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PROPOSED COAL PRODUCT VALUATION RULES

HEARING

BEFORE THE

SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION

OF THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON THE

PROPOSED RULES ISSUED BY THE DEPARTMENT OF THE INTERIOR RELATING TO THE VALUATION OF COAL PRODUCTION FROM FEDERAL AND INDIAN LEASES FOR ROYALTY PURPOSES

NOVEMBER 16, 1987

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PROPOSED COAL PRODUCT VALUATION RULES

MONDAY, NOVEMBER 16, 1987

U.S. Senate,
Subcommittee on Mineral Resources
Development and Production,
Committee on Energy and Natural Resources,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-366, Dirksen Senate Office Building, Hon. John Melcher, presiding.

OPENING STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator Melcher. The subcommittee will come to order.

This morning we are conducting a public hearing on the proposed rules that have been issued by the Department of the Interior relating to the valuation of coal production from Federal and Indian leases for royalty purposes.

Early this year the Mineral Management Service issued its proposed rules on coal product valuation. Those rules would base the value of coal on the gross proceeds obtained under an arm's length contract. The rules would exclude Federal black lung excise tax payments and abandoned mine land payments from value, but would include State severance taxes. The rules also provide for certain processing and transportation allowances.

Considerable controversy and concern arose immediately after the rules were published. In fact, the controversy was of such a degree that I felt it necessary for implementation of the rules to be delayed to allow a further hard look at these proposals by industry, the States, the tribes and Congress. As a result of a congressionally imposed moratorium, Mineral Management Services has not implemented these rules and has accepted additional public comment on them.

A significant alternative proposal for coal product valuation has been submitted by a joint industry group. This proposal would base value on the depletable income provisions of the Internal Revenue Code.

However, several western governors have voiced concern over this concept of valuation. A draft analysis by MMS indicates that the proposed industry approach would result in significantly lower royalty revenues to the Federal Government, to the States and to the Tribes.

And so, that sets the stage here this morning. We want to hear testimony about this issue, make a public record of it, and make sure that we're exerting our oversight responsibility to ensure that the Federal Government, the States and tribes receive a fair return on these coal resources, while at the same time allowing for a healthy coal industry and a secure supply of this important energy source for our country.

Well, those are my opening remarks. We're going to start hearing the witnesses and putting the facts, as they see it, on the public record. And our first witness will be Martin White who is Chairman of the Board and Chief Executive Officer of Western Energy Company. While their office is in Butte, Montana, their principal action in mining coal is in Colstrip, and that's in Rosebud County in Montana and happens to be my home county in an area with which I am very much familiar.

So, Martin, are you here? Yes, right there.

I think we'll ask David H. Peterson who is Director of Fuel Supply, Northern States Power in Minneapolis to come forward too and be at the witness table. And we'll hear the testimony first of Martin White and then, secondly, we'll hear from David H. Peterson.

We were also going to hear testimony from the President of the Colorado-Ute Electric Association from Montrose, Colorado to testify for the National Rural Electric Cooperative Association. I am sad to say Mr. Girts Krumins, who is the President of that electric co-op, wasn't able to get here. Is anybody else from NRECA here to testify? I don't believe so. I think we have been told that they would like to submit a statement for the record. And of course, their statement will be made part of the record immediately following the testimony of Mr. White and Mr. Peterson.

Would you proceed, Martin? Welcome to the committee. I'm glad you didn't get balled up in any airplane troubles getting here from Montana.

STATEMENT OF MARTIN A. WHITE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, WESTERN ENERGY CO., ON BEHALF OF THE NATIONAL COAL ASSOCIATION AND THE AMERICAN MINING CONGRESS, ACCOMPANIED BY DON COOVERT, DIRECTOR OF TAXES, AMAX COAL CO.

Mr. White. Thank you, Senator.

You have pointed out my position in the company with which I'm affiliated. I'm also appearing today, Senator, on behalf of the National Coal Association and the American Mining Congress. And of course, I'm representing Western Energy Company.

I wish to address the joint industry Federal coal royalty valuation proposal, as well as the Federal royalty policies in general.

And Senator, accompanying me today is Mr. Don Coovert who serves as Director of Taxes for Amax Coal. And he is the chief architect of the industry proposal on Federal coal royalty valuation, and he will respond to any questions that you might have relative to that proposal.

And I think, Senator, you are very aware of how much coal we've produced, but just to put it in the record, we have produced approximately 150 million tons from our mine at colstrip. And of that, 55 million tons were produced from Federal leases.

We view the increase in the Federal royalty costs with great alarm. And we believe that the Federal royalty policy in general and the MMS proposed coal product valuation regulations specifically will adversely affect the market for Western Coal, that it will jeopardize coal's share of the electric generation, and that it will act as a brake on the economic development in the United States.

From the time of passage of the 1920 Federal Mineral Leasing Act until the 1970's, the government has recognized the difference between coal and oil and gas in its leasing policies. However, a concern developed over Federal coal leasing when the Arab oil embargo and later the Iranian crisis drove the price of oil to unprecedented levels. And eventually that price increase caused a shift to coal. And that shift created quite an alarm, as you are very aware. One of the documents that was prepared, the North Central Power study, was referenced many times as a reason for changing the Federal coal leasing program, and I believe was instrumental in causing the Federal Coal Leasing Amendments Act of 1976 to occur.

The 12½ percent royalty established by this act represented a significant departure from past Federal leasing practices by not only increasing the royalty rate above what was being charged by any other leasing entity, but by changing the method of calculating the royalty from a cents per ton to a percent of the gross selling price or value at the point of sale.

We understand the 12½ percent was arrived at because that was what had been and was being charged on oil and gas production. And as you know, Senator, so well because your home county has both coal production and oil production, coal and oil are developed, produced and marketed in much different manners. To assess royalties in the same manner does not recognize that difference. It has created a situation where Federal coal royalties are about three times as high as private coal royalties.

Senator Melcher, this difference increases the cost of producing coal at Colstrip about the same as if you were to put 80 to 100 feet of overburden over our coal and cause us to mine that.

[The prepared statement of Mr. White follows:]

NATIONAL
COAL
ASSOCIATION

COAL

November 13, 1987

The Honorable John Melcher
Chairman, Subcommittee on Mineral
Resources Development & Production
United States Senate
362 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

An inadvertent error was made in the preparation of the testimony of Martin White. The testimony should be corrected for the record as follows:

Page 1, third paragraph, last sentence should read:

"Since 1968, when Western began operations at the Rosebud Mine at Colstrip, we have produced approximately 115 million tons with about 55 million tons being federal coal."

We'd appreciate your including this information as part of the hearing record.

Sincerely,

Bruce H. Watzman

1130 Seventeenth Street, N.W.
Washington, D.C. 20036-4677
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The Mining and Reclamation Council of America
Together a stronger voice for coal

Statement of

Martin A. White

Chairman & Chief Executive Officer

Western Energy Company

and

President of Entech

on behalf of

The Western Energy Co.

The National Coal Association

and

The American Mining Congress

before the

Senate Energy & Natural Resources Subcommittee

on

Mineral Resources Development and Production

November 16, 1987

Mr. Chairman, members of the committee, my name is Martin White. I am Chairman and Chief Executive Officer of Western Energy Company and President of Entech, the non-utility arm of the Montana Power Company. I am appearing today on behalf of the National Coal Association and the American Mining Congress as well as Western Energy. I wish to address the joint industry federal coal royalty valuation proposal as well as federal royalty policies in general.

Accompanying me today is Mr. Don Coovert who serves as Director of Taxes for Amax Coal. Mr. Coovert is the chief architect of the industry proposal on federal coal royalty valuation. He is prepared to respond to any questions you or other members of the committee might have. I will direct my remarks to the effect the federal royalty has on the marketability of federal coal, and more specifically, its effect on our mining operations in Montana.

First let me explain a bit about Western Energy Company and Entech. Western Energy mines coal in Montana, Texas and Wyoming. In 1986, Western and its subsidiary, Northwestern Resources Co., produced approximately 16.5 million tons of coal. Since 1968, when Western began operations at the Rosebud Mine at Colstrip, we have produced approximately 115 million tons with about 55 million tons being federal coal.

Western Energy Company views the increase in federal royalty costs with great alarm. We believe that federal royalty policy in general and the MMS proposed coal product valuation regulations specifically will adversely effect the market for western coal, that it will jeopardize coal's share of electrical generation and that it will act as a brake on economic development in the United States.

A brief review of the history of federal coal royalties may be helpful.

Until 1906 federal lands settled under the Homestead Act of 1862 passed to the new owner in fee simple title with no mineral reservations. In 1906, President Roosevelt withdrew large acreages in the West, partially due to concerns that mineral interests were using the Homestead Act as a method to "tie-up" large blocks of land for their own use, and that the public was not well served by such developments. Efforts to open these lands to settlement culminated in the Stock Raising Homestead Act of 1916, which reserved coal and other minerals to the ownership of the federal government. By 1920, the desire to promote mineral development on federal lands led to the passage of the Mineral Leasing Act, which established a comprehensive leasing policy for coal, oil and gas, potash, sodium, phosphate, and certain other minerals.

The 1920 Act was designed to promote development and insure a fair return to the public for the use of its minerals. Coal royalties were generally established at a minimum five cents per ton. Royalties for oil and gas were established at 12.5% in known valuable areas. Over the years, until 1971, coal leases were issued at rates ranging from 5 to 20 cents per ton. In response to increased demand for federal coal in the late 1960s, the Bureau of Land Management re-evaluated its leasing policies and as a result, leased coal lands on a minimum cents per ton or percentage of value basis -- whichever formula yielded the greater value. On August 13, 1974, in response to questions before the House of Representatives Subcommittee on Mines and Mining of the Committee on Interior and Insular Affairs, Department of Interior officials outlined changes in policy that had occurred. By that date, the recommended royalty for strip mined coal was 6%

of value, or not less than 17.5 cents per ton the first ten years, and not less than 20 cents thereafter.

However, by the early 1970s there was growing concern about coal mining and federal coal-leasing policies in general. That concern focused on fears about speculation and the small amount of federal coal production from leased lands. Even though the federal coal under lease by the early 1970s represented only about 4% of total federal reserves there was great alarm about the lack of production on those leased lands.

A part of that concern emanated from a basic confusion as to the nature of the differences between mining coal and developing oil and gas. Oil exploration and development revolves around finding the product and bringing it to the market place, where it is sold as a commodity. Coal exploration and development is fundamentally different, because in coal exploration and development, success hinges on finding and developing markets for a coal reserve. Thus the holding period between leasing and development is necessarily longer. Failure to recognize these differences had serious long term consequences.

Nowhere are those consequences more unfortunate than in the percentage coal royalty system established by the Federal Coal Leasing Amendments Act of 1976 (FCLAA). FCLAA established a royalty of "not less than 12.5 percentum of the value of coal as defined by regulation, except the Secretary may determine a lessor amount in the case of coal recovered by underground mining operations." FCLAA was a radical departure to past leasing practices. Prior to passage of FCLAA, federal coal leases had generally been issued on fixed cents per ton basis. Such a system had much to recommend it, particularly in terms of royalty management. Collecting royalties involved a volumetric measurement of tons mined and applying the appropriate cents per ton rate. Disputes were generally limited to disagreements over tonnage amounts.

That system stands in sharp contrast to the valuation that is now being advocated by the Department of Interior. Federal percentage royalties are now assessed as a percentage of value at the point of sale. The Departments proposal equates "value" with "gross proceeds" and attempts to capture anything paid to a coal operator or anything that should have been paid subject to interpretation of the Department. The fact is that the "gross proceeds" has had historical application by MMS to oil and gas, but not to coal. The administration of federal coal percentage royalties has changed from the historical relationship of a royalty being an amount paid to the property owner for use of his property to one of tax collector/joint venture partner as the federal government attempts to collect royalties on other taxes imposed, take or pay reimbursements, and various allowances for transportation and coal washing. Perhaps the clearest indication of this new relationship is the recent proposal by DOI that includes a provision enabling the MMS to collect royalty on an amount that the Department thinks the operator should have received. Such a system begs for a return of the simplicity of earlier years.

The linkage that occurred between coal and oil and gas in terms of royalty treatment in the mid 1970s was unsupported by the facts at the time and the situation has worsened since then. Again, this linkage sprang from failure to give adequate recognition to the key differences between coal and oil and gas businesses. In the 1970s, there was great concern that the federal government was being "taken for a ride" with low coal royalties. At the time, perhaps some of this concern was justified. However, there was no real need to change the entire royalty system to a percentage basis. If Congress had determined that a fixed uniform cents per ton figure was inappropriate, it could have established new cents per ton royalties and indexed those new figures to hold their value over time. Evidence was available in the early 1970s to demonstrate that the federal government was not receiving significantly less in royalty rates than was occurring in the private sector. Today the federal governments royalty rate far exceeds those in the private sector. On analysis, we found that in the vast majority of cases, private lessors require a royalty payment of 4% of realization. However, with the OPEC oil embargo of 1973-74, and the tripling of the price of oil, a new age had apparently dawned. Policy makers at the time believed that coal would fill the gap and that the demand for coal would increase so rapidly that federal production would play a huge role.

Little thought was given to the potential market disruption that a 12.5% or greater royalty would cause. With forecasts of ever increasing coal usage and coal prices, potential market disruptions were brushed aside. Reality has painted a different picture. Indeed, the nation's coal and electric utility industries geared up to use coal. Generation of electricity by coal has increased from 43% of total generation in 1973 to 57% by 1985. Coal consumption in the United States has grown from 556,022,000 tons in 1973 to 801,165,000 tons by 1986. Federal coal production has grown from 14,033,000 tons in fiscal year 1973 to 163,900,000 million tons in fiscal year 1986. The 1986 figure represents about 18.5% of the total United States coal production. However, these increases did not meet the optimistic projections of the mid 1970s, and prices for coal have declined, in real terms, by 35% since 1975.

Most of the increased federal production is coming from the pre-FCLAA leases. The marketplace has yet to deal completely with the FCLAA imposed 12.5% federal royalty. Obviously, the cents per ton leases represent the vast majority of federal coal produced.

Generally, the last leases issued on a cents per ton basis were issued in 1971. The average royalty on those leases is now 20 cents per ton. At the end of their 20-year term those leases will be readjusted. Thus, by 1991 the bulk of those old leases will be subject to adjustment. Currently, the Department of Interior is taking the position that all surface mining leases must be readjusted to 12.5%. This issue is being litigated in several different federal courts. With the recent decision by the 10th Circuit Court of Appeals favoring the Department, this issue may come before the United States Supreme Court.

Should the federal royalty ultimately be established at 12.5% or more, it will have serious economic consequences for the United States. Currently, federal coal is used by utilities serving all or a portion of 27 states including all states west of the Mississippi plus Illinois, Indiana, Louisiana and Michigan and Wisconsin. As mentioned previously, the 1985 average royalty for all federal coal was 62 cents per ton. If that royalty had been at the full 12.5% rate, an approximate additional $1 per ton would have been added to the coal price for those utilities. In other words, fuel costs would have gone up by over $166,000,000. This would have impacted residential and industrial consumers throughout large regions of the United States. Indeed, this impact will be even greater in the future, as private, state and Indian coal royalty rates rise near the federal rates. Higher electricity costs would increase the cost of manufactured products, which would further increase the use of imported products and imported energy while simultaneously reducing the competitiveness of American goods in the world marketplace. It is good public policy to restrict these coming increases in federal royalty costs that will ripple through the entire United States economy.

Basically there are two fundamental issues concerning the federal royalty policy. One involves the level of the royalty, and the other involves the administration of that royalty. Congress established the level of the royalty and left to the Secretary the discretion to determine the value of the coal and administer that royalty. Much of the federal coal being sold now is the result of long-term contracts with utilities signed prior to the passage of FCLAA. These contracts traditionally contained provisions to protect the producer by clauses that allowed him to "recover" increased costs as a result of changes in taxes, royalties and regulations.

The value of the coal was established at the time of the transaction. Later changes to the price as the result of government action -- such as enacting percentage royalties, federal reclamation fees, black lung taxes, or actions by state government, such as enacting severance taxes -- do not add value to the coal. These actions simply increase the price of that coal. Since the royalty is designed to capture the value of the coal, a system that assesses royalty on total price captures more than the Congressionally mandated "value" of the coal.

We believe that the current method of royalty collection and the method proposed by the Department in January of 1987 is inappropriate, and we believe we have a better solution for valuation. Earlier this year the coal and utility industries submitted an alternative valuation proposal to the MMS. I would like to submit for the record a copy of the proposal as well as comments submitted in support.

The Joint Industry Proposal embraces three fundamentally sound valuation concepts which are:

1. The use of an already established, universally available, well defined benchmark as the starting point for the valuation process, which is gross income from the property as defined by Internal Revenue Code Section 613 and related regulations -- commonly referred to as depletable income.

2. The use of a fixed physical valuation point at which all federal coal would be valued.

3. The application of valuation adjustments to convert producers' gross income to the value of produced coal.

This method of royalty has much to recommend it. It is easy to administer for both parties. The depletion-based approach is patterned on the IRS depletion allowance. Since depletion has a thirty-year plus history, most of the legal questions about what is or is not an allowable mining practice have been settled. The industry depletion-based approach is easier to audit, and less controversy will surround this program. Also, it will be self-policing, since it is in the producer's economic interest to include every allowable item in the depletion base. In short, we feel the advantages offered by the industry depletion based approach will truly reflect value and will be a simpler, more effective and fair system to assess royalties.

The valuation adjustments contained in the Joint Industry Proposal remove Black Lung Excise Tax, Abandoned Mine Land Fees, and state severance taxes from the mining companies' gross receipts in order to arrive at the value of produced coal. Direct federal or state levies upon coal, which frequently can total more than 40% of its cost, may each have merit individually. However, the imposition of such levies upon coal, without enhancing its quality or desirability in the marketplace, does, in fact, reduce -- not increase -- its value. The point is that if an individual levy is imposed at a given rate, it should not be allowed to escalate beyond legislative intent, due to its interaction with other government levies, taxes and fees. Each levy imposed by the government should stand on its own merits, and be collected at the prescribed rate. Administrative procedures should not be allowed to increase such levies through continuous cross-compounding to infinity. MMS has partially recognized the inherent deficiency of cross-compounding policy by proposing deductions for Black Lung Excise Tax and Abandoned Mine Land Fees. The Joint Industry Proposal carries this concept to its logical conclusion by providing for the removal from the base of the royalty itself, and state severance taxes based on production as well.

The depletion based approach is not a new idea. The Commonwealth of Kentucky has used this approach for several years in the administration of its ad valorem severance tax, with highly satisfactory results. Kentucky's administration is simple and highly efficient. Audits involve tying in monthly reports with annual federal income tax returns, checking to see that gross income from the property was properly determined, and reviewing IRS audits for changes in depletable income.

The Joint Industry Coal Royalty Valuation Proposal is intended to be a fair valuation methodology that can be efficiently and accurately administered by both producers and government administrators. We believe these objectives will be achieved if the concepts embodied in the proposal are adopted by the Minerals Management Service. There has been considerable debate regarding the revenue impacts of our alternative. Early in the process, we, because it was not being done elsewhere, prepared a revenue analysis which relied upon information provided by the Bureau of Land Management. Its purpose was to measure, on an estimated basis, the order of magnitude of the difference between the two proposals. It was never intended to accurately analyze the fiscal impact. The limited scope and abbreviated nature was explained to the MMS when the information was provided. Shortly thereafter, the MMS prepared an internal analysis, and in the process prepared a critique of the work we had done. We are concerned, as they were, that many of the assumptions employed do not truly reflect the market conditions. As such, we have just completed a state-by-state analysis which we believe provides the most realistic picture of the nature and fiscal impact of the MMS royalty valuation proposal, compared to the alternative we submitted. I would ask that it be included as a part of these proceedings.

The real problem with the federal royalty, be it the statutory rate or the method of valuation, is its effect on the marketability of the product. I would like to illustrate the problem the federal royalty causes at an operating mine like our Rosebud Mine at Colstrip, Montana.

At Colstrip, we mine the Rosebud Seam which is approximately 25 feet thick. To recover coal from that seam, we have to work with stripping ratios that average 3 and 4 to 1. That is, we have to remove 3 to 4 times as much dirt to recover a ton of coal. We at Colstrip move dirt about as cheaply as anyone in the business. Our costs are from .25 to .30 cents per yard. However, increases in the federal royalty due to readjustment and to the method valuation will add from .80 to $1.00 to the cost of mining at Colstrip. That is equivalent of burying our reserve with another 80 to 100 feet of dirt. The market for coal will not support such increases in cost. The federal coal will stay in the ground.

As a coal producer, we have watched and personally experienced what happens when the price of our coal gets too high. As you would expect, customers stop buying. This is true, even if you have long-term contracts with "pass-through" provisions. The customer will find a way to reduce his take of coal.

It is my personal belief that if the federal royalty policies are not changed, the long-term trend will be clear. Utility customers will move away from federal coal production in the short-term and away from coal as the fuel choice in the longer term. Competing forms of energy, such as imported electricity, imported petroleum or natural gas, will play a much larger role in the generation of electricity. Coal production is presently demand limited; raise the price and you lower the demand further. Secondly, if you raise the price of coal, you also raise the price of electricity, which in turn hampers demand and raises the cost of American goods and services to the domestic and the world markets.

I believe it is good public policy to keep the cost of energy as low as possible. We believe that our depletion-based approach to valuation will help restrain the impacts of federal royalties on our economy. It is not the final answer, but it will help. We urge this committee to encourage the Department of Interior to adopt the depletion-based approach to valuation for federal coal royalty purposes.

Thank you for this opportunity to present our views.

Attachments To
The Statement Of
The National Coal Association
And
The American Mining Congress

To

Senate Energy and Natural Resources Subcommittee

On

Mineral Resources Development and Production

November 16, 1987

Attached for the Subcommittee's review are the comments submitted by the coal industry to MMS on the coal product valuation proposal of January 15, 1987. These comments address the major policy and technical deficiencies of the MMS proposal, and they provide detailed explanations of the alternative approaches suggested by the industry to MMS.

Since at least 1975, DOI has had a regulation in place defining how percentage royalties are to be calculated (40 CFR 41137). Its current version covers less than one column in the Code of Federal Regulations (30 CFR §203.200(f)) and is relatively straightforward.

> "Where Federal Royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine."

Furthermore, in every coal lease issued or readjusted since the enactment of FCLAA, the Federal Coal Leasing Act Amendments, there is a specific lease stipulation (see DOI lease form dated April 1985, Part II, Sec. 2(a)) that states:

> PRODUCTION ROYALTIES -- The royalty shall be of ___ percent of the value of the coal produced. . .

It is particularly important to note that under the provisions of every DOI coal lease, royalties are production royalties, and are payable only on coal produced.

The MMS proposal would change this approach for ad valorem leases for coal sold pursuant to arms-length contracts. MMS proposes to give its regulators unrestrained discretion in defining value for percentage royalty purposes by employing the concept of "gross proceeds" as the benchmark for valuing coal. While the "gross proceeds" concept has had historical significance in oil and gas valuation, it has had none in coal and constitutes a major and inappropriate change from past practice. The regulations must recognize that the coal industry is distinct and economically different from the oil and gas industries:

- The development of a coal mine is capital intensive -- which is not the case with oil or gas.
- Western coal mines were developed under long-term contracts, executed before mine development began; oil and gas are sold at posted or field prices.
- If an oil or gas producer does not like the posted price, it can cap its well; western coal producers do not have that privilege -- they cannot stockpile coal and, in order to hold their federal leases, must meet the diligence requirements imposed by the 1976 FCLAA.

The gross proceeds concept would create serious problems for coal producers and their customers. For example, take-or-pay payments would now be included for valuation purposes. Also, the gross proceeds concept fails to recognize real world coal economics.

- The majority of western coal mines were built in the early and middle 70s under long-term contracts guaranteeing the federal lessees adequate returns on their investments.
- Contract prices went up during the inflationary period of the late 1970's and early 1980's while market prices went down as a result of excess capacity, sluggish demand, and declining prices of competing fuels. This resulted in contract prices far in excess of prices on the spot market.
- Pressure from State regulatory authorities and electricity ratepayers has resulted in litigation, arbitration or hard-nosed negotiations, with utilities seeking price concessions, volume concessions, or both. Utilities burning western coal and their coal suppliers have been forced to amend, modify, or indeed, cancel these long-term contracts.

In such cases, customers may make payments to the lessee designed solely to compensate the lessee for costs incurred in opening a mine and other losses flowing from the lessee's inability to produce and sell coal as contemplated in the original contract. This could include damages for breach of a coal contract, arrived at after good-faith negotiation in settlement of a dispute involving the lessee's performance under the contract, and not based on the value of any coal production. Regulations should not be finalized which permit MMS to levy royalties on compensation or consideration received under a settlement agreement which recoups, at least in part, the federal lessee's investment in his coal mine, in return for a modification of the original contract.

The coal industry (NCA/AMC) has offered solutions to these and other important problems based on sound policy considerations. These include:

- The federal coal royalty, where applicable, be payable only on coal produced.
- The government in developing coal product valuation regulations should adopt a well defined starting point for the valuation process beyond which all value added, through the application of down-stream processes, would be excluded from the royalty calculation.
- To accomplish this the government should adopt a fixed physical valuation point at which all federal coal would be valued.

The joint industry "depletion" alternative would accomplish these ends. By its very nature, this approach would exclude take-or-pay, outbound transportation costs, beneficiation and "other considerations" if it is provided beyond the point of first marketable condition.

Finally, it is crucial that the final regulations be prospective in nature and not upset existing contractual arrangements. The respective rights and obligations of the coal producer/seller and the consumer should be respected. The fidelity of long-term contracts, and their amendments and modifications should be honored and not be subject to reinterpretation by regulators positioned to pounce on their overly-expansive definition of gross proceeds.

At the very least,

- The proposed regulations should have no applicability to arm's length coal sales contracts executed prior to the proposal, whether or not amended or modified prior or subsequent thereto.

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April 15, 1987

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Dear Mr. Whitcomb:

This letter represents the comments of the National Coal Association and the American Mining Congress regarding the proposed rule published on January 15, 1987, by the Minerals Management Service (MMS), in the Federal Register, Volume 52, No. 10, at pages 1840. The stated purpose of the rule is to amend and clarify the regulations governing the valuation of coal for royalty purposes.

For your information, these comments were developed by the Coal Leasing Committees of the NCA and AMC who together represent most of the nation's producers and suppliers of bituminous coal and who have and continue to play a vital role in the federal coal leasing program. We welcome this opportunity to comment on these draft regulations which, contrary to MMS belief, will have a significant and long-lasting impact on every federal coal lessee.

GENERAL COMMENTS

At the outset let us state our disappointment and frustration with both the substance of the proposed regulations and the procedures MMS has employed in developing the proposal. For the past four years, coal industry representatives, either individually or through the associations, have worked with the MMS to fine-tune the proposal prior to its publication for comment. Regrettably, each iteration has gotten progressively worse because of the MMS belief that all energy sources, i.e. oil/gas and coal, should be treated in a consistent manner. This is not only ill-advised but without legal authority. We recognize that improprieties have been documented in the federal oil and gas royalty program, but caution MMS not to interpret this as a mandate to accomplish regulatory overhaul of an entirely different industry. There is evidence throughout the proposed rule of MMS bias to overlay oil and gas procedures onto the coal program. Indeed this bias was highlighted at a March 31 meeting of the Royalty Management Advisory Committee, Denver, Colorado, where the Director of the MMS stated his belief that many of the principles applicable to oil and gas were equally applicable to coal.

The proposed rule, if adopted in its present form, would substitute new regulations spread out over 8 pages of the Federal Register Notice of January 15, 1987 (preceded by 9 pages of explanatory preamble) for existing rules which cover less than a single page in the Code of Federal Regulations (30 C.F.R. 203.200(f), (g) and (h)). The new proposal, according to its drafters, is required "because" it "primarily consolidates and streamlines existing regulations * * *" 52 FR 1847; and Department officials have certified that the proposed rule "is not a major rule" (discussed infra). Such assertions are simply untrue.

The proposed rule constitutes major and substantive changes in coal royalty valuation which, in turn, would create major disincentives to the leasing of federal coal, its development and sale. As stated by a representative of the major association of investor-owned utilities at the March 3, 1987 hearing on the proposal[1] --

> DOI regulations will have a great deal to do with the ability of federal coal to compete in the open market with other fuels and other coals.

Even the most casual examination of the proposed rule makes clear that its effect was not to "consolidate" existing rules, not to "streamline" existing rules, and not to "clarify" existing rules (52) FR 1940; see also 1847); but, rather, to impose on the producers of federal coal and the consumers of that coal a new and complex regulatory scheme, a major rule, of doubtful legal validity in an area where the need for reform and re-regulation has not been demonstrated and clearly is not needed. For example:[2]

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[1]. Statement of Kenneth L. Ladd, Southwestern Public Service Company, speaking on behalf of his company and Edison Electric Institute.

[2]. The detailed, section-by-section comments of the coal industr follow this introduction.

- The concept of valuing coal utilizing "gross proceeds" is the ultimate benchmark cannot be justified for our industry. The new concept constitutes a major departure from the existing method of valuing coal for federal royalty purposes -- i.e., valuation based on the severed or produced product at the point of severance or production. Whatever historical validity the concept has had in the oil and gas industry, coal is not oil and gas, and oil and gas are not coal. The industries are distinct and different. For example -

  - the development of a coal mine is capital intensive -- that is not the case in oil and gas.

  - coal is sold, for the most part, under long-term contracts, most often obtained before mine development begins. Oil and gas are generally sold at posted or field prices.

  - If an oil or gas producer does not like the posted price, it can cap the well. Western coal producers do not have that option -- they cannot stockpile coal in large quantities over a lengthy period.

- The fact is while the "gross proceeds" concept has had historical significance in oil and gas valuation, it has had none in coal and constitutes a major departure from past practice. The words "gross proceeds" do not appear in the MLLA, as amended, existing coal regulations or federal coal leases. For coal, the "gross proceeds" concept has no basis in law. Under Section 7 of the MLLA, percentage royalties are based on "value," and under the current MMS regulations, percentage royalties for coal are based on the "gross value at the point of sale, normally the mine * * *" (30 C.F.R. 203.200(f)); and under the BLM current coal lease forms, percentage royalties are based on the "value of the coal produced * * *." (Part II, Section 2(a); PRODUCTION ROYALTIES).

  Clearly, therefore, the DOI proposal does not constitute mere clarification, consolidation, or streamlining -- the new "gross proceeds" concept proves otherwise.

- Turning to other aspects of the proposed regulations, it is manifest that they do more than codify existing concepts. For example --

  - The proposed regulations would limit the washing and transportation allowances to 50% of the value of the coal. The current regulations do not.

- The new rules propose a 75% limitation for the combined cost of transportation and washing. The current rules and MMS practice contain no such limitation.

- The proposed rule treats "take or pay" payments as part of "gross proceeds" for royalty valuation purposes. The current coal valuation regulations do not -- under them, royalties are paid on the value of coal severed and produced, and not on damages, remedial provisions, options or other devices resulting in cash flow under a sales contract for coal that is not produced.

- The proposed rule substitutes a new and expansive definition of an "arm's-length-contract" for the simple treatment given to such contracts under the current regulations -- i.e., a contract between the federal coal lessee and a purchaser that "is * * * a bona fide transaction between independent parties * * *." 30 C.F.R. 203.200(g)(2). Indeed, the proposed rule contains 26 new definitions for coal valuation purposes.

The above examples are but a few of the many instances where the proposed rule deviates from the law as well as current DOI regulations and practices. The proposal simply does not constitute "consolidation," "streamlining" or "clarification". Rather, it constitutes a massive re-write of current law and DOI rules and practices. It should be called what it is: MAJOR RULE MAKING.

The failure of the drafters of the proposal to recognize the dimensions of their actions has serious legal consequences that can only be rectified by a withdrawal of the proposed rules, until the preparation by DOI of a full and complete regulatory impact analysis.

Indeed, the Secretary of the Department of Interior has unique responsibilities in this matter. He is the steward of the nation's public lands; as such, he is keenly aware of the well-documented fact that western coal prices are currently at all-time low levels. cf. 52 FR 1541: MMS "believes" the proposed valuation methods would yield a maximum return for federal lands. It is the Secretary's job to make certain that the Department and MMS not only face up to statutory requirements, but that its policies and programs encourage, and not discourage, the development and sale of the nation's coal resources.[3] Such a course, and no other course, will result in the maximum return for federal coal to the government.

REGULATORY IMPACT ANALYSIS

Executive Order 12291 states, inter alia, that its purpose is "to reduce the burdens of existing and future regulations" (preamble); that in reviewing existing and promulgating new regulations agencies "shall set regulatory priorities with the aim of maximizing the aggregate new benefits to society, taking into account the conditions of particular industries affected by the regulations * * *" (Sec. 2(e)); and to prepare a detailed economic analysis for a major rule. (Sec 3). A "major rule" as defined in (Sec. 1(b)) as one that is, alternatively, "likely to result in" --

> "(1) An annual effect on the economy of $100 million or more;
>
> (2) A major increase in costs or prices for consumers, individual industries, * * * geographic regions; or
>
> (3) Significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of the United States-based enterprises to compete with foreign-based enterprises in domestic or export markets."

To date, MMS makes no claim that it has made the economic analysis required by law. In our view, that failue contravenes the law because the proposed rule is a "major" federal action. While the Department has asserted that its action is not a "major rule", in the "DETERMINATION" it issued, there are no findings, as indeed there could not be that its proposal will have an impact on the economy of less than $100 million; that its proposal will not result in a "major increase" in coal prices to consumers; or, most importantly, that the proposal will not result in "significant" adverse economic effects on the industry and its customers.

The basis of the DOI determination that the proposed action is not a "major rule" under EO 12291 is a document entitled

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[3]. In its Energy Security Report to the President of the United States, U.S. Department of Energy, March 1987, DOE emphasized the need to "Evaluate whether current royalty rates are constraining the efficient development of coal on Federal lands." Percentage royalty rates are, of course, applied to valuation.

"DETERMINATION OF EFFECTS OF RULES," signed by the Director of MMS on November 24, 1986, and concurred in by an Acting Assistant Secretary - Land and Minerals Management on November 26, 1986. In that document, the MMS Director certified (Section 8), and the Acting Assistant Secretary concurred (Section 10), that under EO 12291 the proposed rule "is not major." We have carefully examined this document.

- It states, *but without any analysis*, that the primary mission of the proposed rule is to consolidate existing rules, to place coal product valuation regulations in a consistent format, and to clarify existing regulations. (Section 4).

- It states that the "NEED" for the proposed rule emanated from Linowes Commission Report, which dealt with oil and gas product valuation problems, and which, quoting Linowes, "*may* be applicable as well to managing royalties from the solid energy minerals." (Section 4, underscoring added). (Indeed, Linowes' use of the word "may," and not "would," suggests, at the very least, that an analysis of the basic differences between the industries is appropriate). But the document contains *not the first word* discussing the basic differences which underly the valuation of oil and gas, on the one hand, and coal on the other hand. Finally -- *and, again, without the first word of proof or analysis* -- it concludes that the "existing [coal] regulations are fragmented and vague, with potential for misinterpretation, which contributes to incorrect product valuation and royalty calculation." (Section 4). Again, this is unsupported by fact or analysis.

The Department's finding that the proposed rule "is not major" under EO 12291 is in error. The Departments' findings that its proposal is in the interest of consolidation, efficiency, streamlining and clarification does not, as we have shown, stand the test of analysis and scrutiny. Nowhere does the proposal even begin to examine its impact on coal producers and their consumers -- an examination mandated by a Presidential Executive Order.

Finally, we caution MMS against promulgating final rules which would have the effect of altering existing contractual relationships between coal suppliers and purchasers. At a minimum MMS should, if it issues final rules, grand-father existing contracts.

We believe the proposed rule should be withdrawn. However, in view of the fact that MMS has requested specific comments, we have attached hereto several suggested revisions in an effort to be constructive. In general, our revisions adjust the proposals to be more in line with the current royalty valuation rules of the Department. Additional language is underscored while language to be deleted is in bold type and bracketed. Justifications accompany each change.

We appreciate the opportunity to file these comments and ask the Department to give them serious consideration. Should you have any questions or require additional information, please do not hesitate to contact us.

Sincerely,

Gregory E Conrad
Gregory E. Conrad
Senior Counsel
American Mining Congress

Bruce H. Watzman
Director, Leasing
National Coal Association

BW:ns
Attachment

July 21, 1987

Mr. Dennis C. Whitcomb, Chief
Rules and Procedures Branch
Minerals Management Service
Building 85, Denver Federal Center
Post Office Box 25165, MS 651
Denver, Colorado 80225

RE: REVISION OF COAL PRODUCT VALUATION REGULATIONS RELATED TOPICS, 43 CFR Part 3480

Dear Mr. Whitcomb:

On behalf of the industries that have been developing an alternative approach to coal product valuation, it is our pleasure to submit the attached alternative proposal to the Minerals Management Service (MMS) for consideration.

The industry alternative is based on rules proposed by MMS on January 15, 1987, at 52 FR 1840 and represents a significant revision of that proposal. Deletions are indicated with brackets and additions are underscored. Detailed justifications accompany each revision. We have attached an executive summary and a comparison chart of various points in the valuation process.

We believe that the approach embodied herein, utilizing the Internal Revenue Service Code for depletion calculations, results in a reasonable and time-tested alternative to the "gross proceeds" methodology advanced by MMS in January of this year.

Our preliminary calculations indicate that this methodology is fair to consumers and should not result in the artificial market impacts that are likely under the MMS proposal. It merits a careful review.

Sincerely yours,

William McCollam, Jr.
WILLIAM MCCOLLAM, JR.
President
Edison Electric Institute

Lawrence S. Hobart
LAWRENCE S. HOBART
Executive Director
American Public Power Association

BOB BERGLAND
Executive Vice President
& General Manager
National Rural Electric
Cooperative Association

Richard L. Lawson
RICHARD L. LAWSON
President
National Coal Association

JOHN A. KNEBEL
President
American Mining Congress

Fred Palmer
FREDERICK D. PALMER
General Manager
Western Fuels
Association, Inc.

EXECUTIVE SUMMARY

COAL/ELECTRIC UTILITY ROYALTY VALUATION PROPOSAL

Executive Summary

Valuation Concept

Coal valuation, for federal royalty purposes, should be based upon the following concepts:

- Value for royalty purposes should be determined at a fixed, defined point in the production process immediately upon completion of crushing and sizing of coal actually mined from federal leases (Point 6 on attached chart).

- Value should be calculated starting with an established and consistent benchmark which is "gross income from the property" as determined in accordance with the provisions of Internal Revenue Code Section 613 and related regulations (Point 8 on attached chart). "Gross income from the property" includes all income generated by mining, basic processing and loading functions. Each mine operated by a coal producer is required by Internal Revenue Service to calculate "gross income from the property" on a mine specific basis to claim statutory depletion.

- Value should exclude all processes and handling beyond the defined point of valuation.

- Value should exclude all direct government levies such as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees, state severance and production taxes.

- To arrive at net royalty value, it would be necessary to make certain mechanical adjustments to the IRC 613 depletion base. Specifically, it would be necessary to add all non-federal royalties attributable to coal produced from federal leases, since these amounts are the only portion of the selling price excluded from the depletion base. It would also be necessary to deduct the processing allowance as well as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees and state severance taxes.

The formula for determining net royalty value in accordance with this proposal may be expressed as follows:

Net Royalty Value = Depletable Income From the Lease + Non-Federal Royalties Attributable to the Lease - Processing Deduction & Direct Government Levies

Impact On Specific Issues

Royalty valuation at a fixed point in the production process using the IRC 613 federal depletion benchmark will produce the following results:

1. Greatly reduce and simplify MMS administrative procedures and costs because the starting point for determining value would be a well-defined and universally available benchmark that is easily verified with a minimum of effort (Point 6 on attached chart).

2. Substantially reduce and simplify coal producer compliance costs in that a simple mechanical calculation would be all that is necessary to remit royalties. It would not be necessary to wade through and/or submit volumes of contractual and financial data, most of which would generate more confusion than fact.

3. Royalty liability, most of which is ultimately paid by electric utility consumers would be a determinable amount not subject to major, unexpected fluctuations and audit changes.

MMS recognized the inherent unfairness of imposing federal royalty on Black Lung Excise Tax and Abandoned Mine Land Fees noting that government could increase its royalty by increasing taxes and fees. The same logic applies equally as well to state severance tax and even moreso to the imposition of royalty upon itself.

Allowing price driven taxes, fees and royalties to cross-apply, each upon all the others, causes the effective rate of each to substantially exceed original legislative intent. We strongly assert that such practices are poor public policy that will negatively impact the development and production of federal coal, in the long term. If there is economic or political justification for the imposition of, or increase in a government levy, legislative bodies should act accordingly. Allowing price driven levies to compound upon themselves, and each other, substantially increases such levies outside the legislative process. We submit that prudent public policy should be that all government imposed taxes, fees and royalties should stand independently on their own merits and be imposed, increased or decreased without interrelated impact.

Conclusion

The MMS proposal in reality ignores basic ad valorem concepts and substitutes totally inappropriate "gross income tax" concepts. If Congress had intended to levy minimum ad valorem royalties in excess of 12.5% (8% for deep coal) or a "gross income tax" on the receipts of mining companies, it would have so indicated. Clearly, Congress did not intend such results. The intent was to levy a royalty on the value of coal actually produced from federal leases.

The attached flow chart visually summarizes the significant issues related to coal royalty valuation. The example mine depicted on the chart is a Wyoming, Powder River Basin, surface mine. Generally, most of the issues are common to all mines.

The advantages of the coal/utility industry proposal in terms of legislative intent, appropriate public policy, administration and fairness are exceedingly obvious. The result would be a smoothly operated royalty program which would be in everyone's best interest. We urge MMS to adopt the depletion based federal coal royalty valuation program set forth in the following comments.

7/013
attachment

October 13, 1987

Mr. Dennis C. Whitcomb, Chief
Rules and Procedures Branch
Minerals Management Service
Building 85, Denver Federal Center
Post Office Box 25165, MS 651
Denver, Colorado 80225

RE: REQUEST FOR COMMENTS ON THE JOINT INDUSTRY ALTERNATIVE TO THE MMS PROPOSED COAL PRODUCT VALUATION REGULATIONS RELATED TOPICS, 43 CFR Part 3480

Dear Mr. Whitcomb:

These comments are submitted in response to the request for comment, appearing in 52 Fed. Reg., No. 155, at page 29868, on the joint industry alternative to the MMS proposed coal product valuation regulation.

As principal proponents of the joint industry proposal we continue to believe that our alternative is far superior to the MMS proposal both in terms of efficiency and administration. We find it to be in the beneficial interest of the states, tribes, coal producers and federal government. While disagreement over what deductions are appropriate exists, none should disagree that it is far superior to develop a program weighed heavily on administrative simplicity and low on manpower needs. We believe our proposal, which can be effectively and efficiently administered with a minimum staffing requirement, as opposed to perhaps the hundreds needed to administer the MMS proposal will benefit both the public and private sector.

The Joint Industry Proposal embraces three fundamentally sound valuation concepts which are:

1. The use of an already established, universally available, well defined benchmark as the starting point for the valuation process, which is gross income from the property as defined by Internal Service Code Section 613 and related regulations - commonly referred to as depletable income.
2. The use of a fixed physical valuation point at which all federal coal would be valued.
3. The application of valuation adjustments to convert producers' gross income to the value of produced coal.

Depletion Benchmark

The depletable income benchmark is proposed because it is consistently calculated by each coal producer on a mine specific basis and is arrived at in accordance with long standing Internal Revenue Service regulations. In simple terms, depletable income is the arms-length selling price of produced coal F.O.B. mine. The alternative proposal by the Minerals Management Service is based upon the gross proceeds of the mining company on a contract by contract basis which requires the accumulation of considerable information that does not exist in any one place.

Fixed Valuation Point

Using a fixed valuation point eliminates confusion over what is or is not included in value and is much more fair to competing coal producers as compared to the floating valuation point proposed by MMS. The industry proposal would value coal for royalty purposes immediately after the product has been crushed and sized. Which, in the vast majority of cases, is when coal from federal leases achieves marketable condition. The proposed valuation point would also prevent the application of royalty to value added by new coal technologies such as liquefying, gasifying and thermal drying.

Valuation Adjustments

The valuation adjustments contained in the Joint Industry Proposal remove Black Lung Excise Tax, Abandoned Mine Land Fees and state severance taxes from the mining companies' gross receipts to arrive at the value of produced coal. Direct federal or state levies upon coal, which frequently can total more than 40% of its cost, may each have merit individually. However, the imposition of such levies upon coal, without enhancing its quality or desirability in the marketplace, does in fact, reduce -- not increase -- its value. The point is that if an individual levy is imposed at a given rate, it should not be allowed to escalate beyond legislative intent due to interaction with a combination of several other government levies, taxes and fees. Each levy imposed by the government should stand on its own merits and be collected at the prescribed rate. Administrative procedures should not be allowed to increase such levies through continuous cross compounding to infinity.

MMS has partially recognized the inherent unfairness of cross compounding by proposing deductions for Black Lung Excise Tax and Abandoned Mine Land Fees. States also have recognized this problem to a degree. For instance, Montana deducts state severance and government royalties to arrive at severance tax value. Wyoming deducts government royalties and post marketable condition handling value for severance tax purposes. The Joint Industry Proposal carries this concept to its logical conclusion by providing for the removal from the base of the royalty itself and state severance taxes based on production as well as Black Lung Excise Tax and Abandoned Mine Land Fees.

Administration

The administrative simplicity of the Joint Industry Proposal is obvious. Valuation would be clearly defined, based on a pre-existing benchmark and sound valuation techniques. Producer compliance and MMS audit work would be on a mine by mine basis using existing rules and available information as opposed to a contract by contract approach based on new and different rules. Since depletable income is virtually always audited by Internal Revenue Service, MMS would enjoy an additional level of comfort as to the reliability of producer compliance.

There is a natural policing aspect of this proposal in that coal producers will maximize depletion.

Because the proposal makes the benchmark for starting the royalty valuation process consistent with the definition of depletable income found in the Internal Revenue Code as of a specific date, January 1, 1987, MMS would have the option to update its regulations should Congress or Internal Revenue Service change depletion rules prospectively. In the rare situation where a federal coal producer is selling coal so far below cost that he does not bother to calculate depletion, a sound set of rules upon which to base value would still be in place.

The depletion based proposal is not a new idea. The Commonwealth of Kentucky has used this approach for several years in the administration of its ad valorem severance tax, with highly satisfactory results. Kentucky's administration is simple and highly efficient. Audits involve tying in monthly reports with annual federal income tax returns, checking to see that gross income from the property was properly determined, and reviewing IRS audits for changes in depletable income. The effectiveness of the Kentucky system is an established fact.

Attached are more detailed comments in support of the joint industry proposal as well as suggested regulatory language where appropriate.

We urge you to give serious consideration to our proposal.

Sincerely,

WILLIAM MCCOLLAM, JR.	RICHARD L. LAWSON	JOHN A. KNEBEL
PRESIDENT	PRESIDENT	PRESIDENT
EDISON ELECTRIC INSTITUTE	NATIONAL COAL ASSOCIATION	AMERICAN MINING CONGRESS

COAL ROYALTY VALUATION ISSUE ANALYSIS

Joint Industry Proposal

The joint industry proposal embodies three distinct concepts, the application of which would result in the following:

Depletable Income As Benchmark Valuation Starting Point

1) **Administrative complexity** - compliance and auditing based on existing depletable income information at mine level would be more efficient and less costly than the use of contract by contract gross proceeds information level that must be accumulated.

2) **Optimum compliance results** - producer will maximize depletion at expense of higher royalty (producer keeps depletion, customer pays royalty). IRS audits depletable income.

3) **New coal technologies** - liquifying, gasifying and drying would not be subject to royalty. IRC does not allow these items to be included in depletable income, because they are not the result of mining.

4) **Royalty compounding upon itself** - IRC precludes depletion of royalty by coal producers. Industry proposes to add all royalties except federal to depletable income for federal royalty valuation purposes.

5) **Separate arms-length pricing determinations** not necessary. IRC provides well established guidelines to convert "captive" prices to arms-length for depletion purposes.

6) **Outbound transportation** deduction not necessary. IRC precludes depletion of o.b.t. and provides mechanism for removal to arrive at depletable income, if necessary.

7) **Hypothetical revenue** (payments for underutilization of mine facilities, uneconomical -- lost production, etc.). IRC does not allow these items to be included in depletable income, because they are not generated by coal production.

Fixed Physical Valuation Point

1) **Greatly reduce disputes over what processes** should be included in royalty valuation.

2) **Complex "washing allowance"** replaced with simple, efficient "processing allowance" mechanism not subject to abuse.

3) **Reduce inequity between producers** because all coal would be valued at the same physical point -- when marketable condition is first achieved.

4) **Reinforces** point that value added by new coal technologies are not subject to royalty because they occur after the point of valuation.

Valuation Adjustments (Black Lung, AMLF, Severance Tax)

1) **Converts producers gross income into product value.**

2) **Separates dual roles of government** as landlord and public policy maker. Allows each fee or tax to stand on its own at the prescribed rate, and not be artificially increased by cross compounding.

3) **Removes compounding effect of federal taxes and fees** interacting with royalty imposed by same legislative body.

4) **Removes compounding effect of royalty on state severance taxes** imposed by the states who receive the largest net share of federal royalty revenue.

Criticisms and Responses Thereon Relative To The Joint Industry Proposal

The depletion based Industry Valuation Proposal will not be significantly more efficient or less expensive to administer than the MMS gross proceeds proposal.

Federal coal is currently produced from approximately 80 mines by approximately 60 companies and sold under more than 200 contracts. Royalty calculation under the Industry Proposal would be done approximately 80 times by all coal producers in each reporting period based upon pre-existing, mine level, information that has generally been accumulated in the proper format, requiring relatively little modification. Under the MMS proposal, a separate calculation of gross proceeds generated by each of more than 200 contracts will be necessary. This will initially involve the analysis of the original contract and each price adjustment from the beginning of the contract through the end of the reporting period to build up the total price received or that could have been received in the current period.

Records necessary to determine and verify royalty value under the Industry Proposal for each of the 12 monthly reporting periods in a calendar year could easily fit into a normal size briefcase. Such records would include, but not necessarily be limited to, the federal income tax return, the certified financial statements and mine operating statements (including cost detail). The records necessary to calculate and verify accumulated gross proceeds using the MMS contract by contract gross proceeds approach could easily fill several file cabinets. Not only are the contracts unique and voluminous, but each individual price adjustment (frequently done quarterly) may involve several hundred pages of calculations and support detail.

The following example illustrates the simplicity and efficiency of the Industry Valuation calculation. The hypothetical mine is a large Powder River Basin surface operation producing 800,000 tons per month, sold for a weighted average price of $10.00 per ton under 5 long term coal supply agreements.

Federal Royalty for the reporting period would be determined as follows:

		(000 Omitted)
	Total Gross Income from the Property (800,000 tons @$10)	$ 8,000
	Deduct: Federal Royalty	(677)
(a)	Private Royalty	(54)
(b)	Gross Royalty Value (Producers Depletable Income)	$ 7,269
(a)	Add Private Royalty	54
(c)	Deduct: Processing (Post Marketable Condition)	(328)
(d)	Black Lung Excise Tax	(337)
(e)	Abandoned Mine Land Fee	(280)
(f)	State and local production Tax	(960)
	Net Royalty Value	$ 5,418
	Federal Royalty @ 12.5%	$ 677

(a) 1% of selling price less all royalties and direct government taxes and fees.

(b) This amount, combined with like amounts from all other reporting periods months in the tax year will match depletable income reflected on the producers federal income tax return depletion schedule, if both are correctly calculated.

(c) Gross royalty value of \$7,269 x $\frac{\text{Post Marketable Cond. Cost \$289}}{\text{Total Depletable Cost \$6,400}}$ = \$328

(d) 4.4% of \$8,000-104.4% + 104.4% (federal excise tax does not compound upon itself)

(e) 800,000 tons @ \$.35

(f) 15% of (sales less deductions of 20%)

The calculation of royalty liability for the same reporting period using the MMS proposed gross proceeds concept would require separate selling price build-up for each of five unique contracts to be multiplied by quantity produced and sold to each customer in the reporting period from the federal lease to arrive at liability. Verification of these calculations would involve at least the following steps:

1. Ascertaining the accuracy of each price adjustment from the inception of the contract through the end of the reporting period.

2. All proceeds flowing from each contract that are **not** related to the production of coal would have to be identified and included, even though they are not normally treated as part of mining income.

3. Since the MMS proposal is based upon a floating valuation point, it would be necessary to calculate and remove part of the value of outbound transportation and washing pursuant to complex and unrealistic netback rules that will seldom yield a proper result.

4. The value of foregone production must be ascertained and added to the value of coal actually produced from the federal lease.

Based upon audit experience discussed later in these comments, the initial field audit of this producer by MMS would take 900 man days, assuming the 5 contracts had been in place for an average of 4 years:

(45 man days/4 years/5 contracts = 900)

Subsequent annual audits would take 225 man days:

(45 man days/1 year/5 contracts = 225)

If compliance is depletion based, on a mine by mine basis, the audit of a year's activity would take no more than 10 man days. The large difference is due to the fact that depletion based valuation utilizes existing information that is repeatedly verified and scrutinized by multiple groups of auditors.

Depletion based valuation is a new and untested idea.

Depletion based ad valorem valuation is **not** a new idea. This methodology has been in place and working in the Commonwealth of Kentucky for more than 15 years. The result has been a high degree of compliance with a minimum amount of administrative cost, including personnel. Kentucky raised approximately $200 million annually in revenue from depletion based coal severance tax paid by approximately 1,200 coal producers, using 15 people including administrative and support personnel. Because depletion based value is so clearly defined, there are very few disputes. Approximately $7 million is currently being litigated in Kentucky for all years. On average, disputed annual liability is substantially less than 1% of collections.

We believe if the Kentucky experience is a fair indication of the effectiveness of a depletion based program. Accordingly, the relatively small federal coal royalty program involving approximately 80 mines operated by approximately 60 companies could be administered with no more than 10 qualified personnel. To be specific, with a 3-year statute of limitation and 60 companies mining federal coal, it would only be necessary to audit 20 companies each year doing 36 month audits in each case. If qualified financial accounting trained auditors are used, three teams of two each could audit six or seven companies each year with ease. In addition to six auditors, it would be necessary to have three or four support personnel to process and math check report forms and administer the program.

Gross proceeds is a more effective and efficient administrative procedure because it is based on the coal supply contract.

It is true that the MMS gross proceeds concept is in part based on the contract. In theory, if all contract terms and subsequent price adjustments are properly interpreted by an auditor, and all costs properly accumulated, the end result will be similar to depletable income except for the inclusion of federal royalty, new coal technology value and possibly deficiency payments. The problem is that it takes an inordinate length of time to arrive at that point using gross proceeds methodology.

Evidence of the efficiency of a depletion based approach can be found in the Kentucky system as previously discussed. Evidence of the time-consuming nature of gross proceeds auditing can be found in the contract administration relationship between coal producers and utility customers. Virtually all utilities field audit coal pricing annually to verify accuracy. Due to the nature of the audits, contract specific gross proceeds methodology is the most appropriate procedure.

Discussions with several coal producers and utilities confirm that it takes approximately 45 man days to audit one year's activity and a substantial additional amount of time to write up the report.

We know that there are more than 200 coal contracts supplied from federal leases and that many of them have been in force for several years. For discussion purposes, assume 200 contracts in force for an average of 4 years each. Based on the audit experience of utility coal buyers, the first year's audits would take 9,000 man days, or at least 164 auditors, based on 220 work days/year allowing no time for report writing or other work. In addition, substantial numbers of support personnel would be needed to handle the huge volume of paperwork. In subsequent years, audit time would be reduced because only one year's activity would be examined. However, there would still be a need for at least 50 auditors, plus support personnel. Contrast these results to the ten people needed to administer a depletion based program based on experience in Kentucky. These projections do not take into account the fact that additional time will be required to write up reports.

The comparative efficiency of a depletion based royalty valuation and administration system is obvious. The inefficiency of a contract specific gross proceeds approach is equally obvious.

Depletable income is a build-up of cost or attributed income and, as such, would be difficult to verify.

Depletable income is neither a cost build-up or a collection of attributed income. Total depletable income for a coal mine is the arms-length selling price of produced coal in marketable condition, F.O.B. mine. This amount becomes the starting point for a coal producer's tax return, including the depletion schedule, virtually all financial accounting records and the certified financial statements. This amount is routinely audited by government agencies, customers, internal auditors and external auditors. This amount is one of the most readily available and consistently calculated pieces of information that exists within the records of a coal producer.

The major difference between depletable income and gross proceeds is that depletable income is intended to include only the market value of produced coal that has been mined and processed to the point that it has become marketable. This contrasts with MMS contract specific the gross proceeds concept which involves the build up of several separate elements of value including additional processes beyond the first point of marketability, receipts not related to coal production and hypothetical receipts related to sales or production that never occurred.

Why should we convert to a new valuation method when we are familiar with the tried and tested gross proceeds approach that was developed by several states in the administration of severance taxes?

It is true that the gross proceeds concept has been developed over several years by states principally for the purpose of administering mineral severance taxes. However, the concept of a royalty is not as broad as the concept of a tax levied for the privilege of conducting an activity such as mining. A royalty is intended to be a share of production while a privilege tax is paid for the right to mine and can be measured by any means desired. If government chooses to levy a tax for the privilege of mining, such a tax can be measured by gross receipts, net income, capital investment, weight, volume, number of employees, or any other appropriate means. On the other hand, a royalty is not a gross receipts or privilege tax. A royalty relates to production of the mineral up to the first point of marketability, not all of the activities of the mining company.

Depletion based valuation rules are too restrictive and rigid, providing little opportunity to deal with unique or unusual problems.

The depletion based valuation proposal, including the mechanical calculations necessary to arrive at net royalty value, are intentionally precise and rigid. We believe valuation rules should eliminate as much latitude from the valuation process as possible. Precise rules and efficient administration equate to equity in the treatment of lessees, which should be a high priority with MMS.

One of the major flaws in the gross proceeds concept is that there is too much latitude for both coal producers and MMS to exercise discretion, thus creating inequity. The majority of coal producers who operate in states where severance taxes are calculated based on gross proceeds methodology are convinced that seldom are two coal producers treated alike. While it is a generally accepted fact that the exercise of discretionary authority on the part of public administrators equates to power, it is equally true that the result is poor administration. Consistency, uniformity and equal treatment of coal producers must be an integral part of the MMS coal royalty program, if it is to succeed.

The Internal Revenue Code and related regulations are difficult to understand.

It is true that the Internal Revenue Code and regulations are voluminous and often verbose. It must be kept in mind that the Code has been developed over a long period of time, serves many and sometimes conflicting interests and is very technical in nature. However, the depletion rules have not followed the same pattern as the Code in general. The basic fundamental concepts upon which the calculation of depletable income is based have not significantly changed since its inception many years ago. Currently, there are very few disputes over what is or is not depletable income to a coal producer.

The same cannot be said for gross proceeds programs as they relate to government levies upon coal at either the state or federal levels. Valuation disputes are more the rule than the exception. Guidelines are difficult to write in precise detail and even more difficult to follow. The resulting inconsistency is not just totally related to the weakness of gross proceeds valuation. Coal supply agreements are more often different than they are alike. The combination of gross proceeds complexity with the unique nature of coal supply agreements equates to unending chaos, serving only the interests of those who benefit from large government and protracted litigation.

If a coal producer is selling coal below cost, thus generating no profit, the producer may not calculate depletable income. Therefore, since there is no depletable income there would be no federal royalty due.

This is not a correct reading of the Industry Proposal. The proposal is specifically designed to prevent this kind of occurrence. The proposed definition of gross royalty value is synonymous with the definition of depletable income found in the Internal Revenue Code. Gross royalty value equals depletable income only when depletable income is correctly determined. If a producer fails to calculate depletable income or incorrectly calculates depletable income, MMS would have the right and, in fact, the responsibility to make appropriate corrections. Even under these unusual circumstances, the existence of a long standing set of rules will make the construction or correction of gross royalty value much easier than by using contract specific gross proceeds methodology.

Coal producers don't comply with Internal Revenue Service depletion regulations.

This false allegation is an obvious attempt to discredit the depletion based valuation proposal and divert attention from the real issues. Compliance with any tax is probably never 100%. However, the Internal Revenue Service pays particular attention to tax preference items such as depletion when conducting audits. The result is a higher degree of forced compliance in the tax preference areas than with general tax provisions. Although the non-compliance allegation is without merit, it is interesting to point out that if coal producers are not complying with Internal Revenue depletion rules, it would mean that they are inflating depletable income. If this were true, federal royalties would be increased, not decreased.

Coal producers would "play" with depletable income to lower federal royalty liability.

Coal supply agreements, virtually without exception, do not provide for the pass through of federal income tax benefits to the coal purchaser. Conversely, the vast majority of coal supply agreements do pass federal royalty costs through to purchasers. It therefore follows that coal producers will maximize depletion (which is their benefit to keep) even at the expense of increasing the federal royalty (which is passed through to the customer).

The Industry Proposal does not provide a mechanism for segregating production on a federal lease from non-federal production at the same mine.

This ia a valid criticism. The Industry Proposal, like the MMS proposal, does not provide an adequate mechanism for segregating or allocating co-mingled federal and non-federal production at the same mine. To correct this deficiency, we propose the following language which provides for a precise segregation or allocation of federal production based upon readily available information. In general, the proposed allocation mechanism would be based upon tons produced from each federal lease as a percentage of total mine tons, and would only be used when actual segregation is not possible

SUGGESTED REGULATORY LANGUAGE

Add a new section 206.255(d) to read as follows:

FEDERAL PRODUCTION SEGREGATION

(A) When total production from a single mine includes production from more than one federal lease or production other than from a federal lease, gross and net royalty value of coal produced from each federal lease must be segregated from other production at the mine on an actual basis to the extent possible.

(B) When production from a mine includes coal from more than one federal lease or production other than from a federal lease, and total mine production is so co-mingled as to preclude segregation and separate identification of the federal portion of gross royalty value, net royalty value or any component thereof (except royalties), such value or components shall be determined in accordance with the following allocation procedure:

> The component being allocated shall be multiplied by a fraction, the numerator of which is the actual number of tons produced from the federal lease in the reporting period, and the denominator of which is the total actual tons produced from the mine in the same reporting period.

The allocation computation may be illustrated by the following:

Surface Mine Example

Assumptions:

- Total mine production for reporting period 1,000,000 tons (800,000 federal, 200,000 private)
- Total mine production sold for $10/ton
- Separate federal and private production are not physically distinguishable
- Federal royalty rate 12.5% of net royalty value
- Private royalty rate $.50/ton
- Overriding royalty applicable to all production
- State severance tax rate of 15% applicable to selling price reduced by various deductions equal to 20% of the selling price
- Total product cost $8,000,000, post-marketable condition portion $361,000 (80% = $6,400,000 and $361,000 respectively)

Federal royalty for the reporting period would be determined as follows:

		(000 omitted)		
		Federal	**Private**	**Total**
	Total Gross Income From The Property	$ 8,000	$ 2,000	10,000
	Deduct Royalties - Federal (actual)	(677)		(677)
	- Private (actual)		(100)	(100)
	- Override (actual)	(54)	(17)	(71)
(a)	Gross Royalty Value - Federal Coal	$ 7,269		
	Gross Royalty Value - Private Coal		$ 1,883	
(b)	Producers Gross Income From The Property			$ 9,152
	Add: Federal Portion of Override	54		
(c)	Deduct: Processing Allowance	(328)		
(d)	Black Lung Excise Tax	(337)		
(e)	Abandoned Mine Land Fee	(280)		
(f)	State Severance Tax	(960)		
	Net Royalty Value	$ 5,418		
	Federal Royalty @ 12.5%	$ 677		

Allocation Factor $\frac{\text{800 Federal Tons}}{\text{1,000 Total Tons}}$ = 80%

Footnotes

(a) Gross royalty value equals 80% of actual gross income from the property reduced by actual federal and overriding royalty

(b) Producers depletable gross income from the property determined pursuant to IRC 613 in effect 1-1-87

(c) $7,269 × $\frac{289}{6,400}$ (removes post-marketable handling value)

(d) 80% of $\left(\frac{10,000 \times 4.4\%}{104.4\%}\right)$

(e) 800 tons @ $.35/ton

(f) 80% of $1,200 actual severance tax

(C) The allocation provisions of Subsection B of this section do not apply to the deduction of royalties from gross income from the property to arrive at gross royalty value pursuant to Section 206.251(k) or the addition of non-federal royalties to arrive at net royalty value pursuant to Section 206.251(k). These components of value must be separately identified and reported for each federal lease on an actual basis.

Internal Revenue Service often keeps the statute of limitation open with respect to corporate income tax longer than three years. Therefore, a change in depletable income after the industry proposed three-year statute of limitation has lapsed would not allow MMS to make a corresponding change in royalty value.

This is a valid criticism. To correct this deficiency, we propose that a limited extension of the three-year statute of limitation be provided only with respect to depletable income issues that have been raised but not resolved in an IRS audit. The following language would provide such a limited extension of the statute of limitation:

SUGGESTED REGULATORY LANGUAGE

Add the following at the end of Section 206.253(g) (from Industry Proposal):

Final MMS audit determination shall be deferred when IRS has audited the lessee's federal tax return for any potion of the same period and the results have not been finally determined with respect to "gross income from the property" as defined by Internal Revenue Code Section 613(c). When such IRS audit results are finally determined, and all appeal rights have expired, the lessee shall forward a copy of the applicable portion of the determination to MMS within 30 days. MMS shall review the final IRS audit results and issue a final royalty audit report within 60 days following receipt of final IRS audit results.

Royalty administration personnel are uneasy about using another agency's guidelines as the basis for their administration.

Decisions such as this should be based upon total government efficiency and cost. If this abstract concern is really an insurmountable problem, a definition of gross royalty value that does not reference the Internal Revenue Code could be constructed that is still synonymous with the depletable income definition. For instance, depletable income is equal to:

the arms-length selling price of produced coal in marketable condition, F.O.B. mine.

Using the above as the definition of gross royalty value, combined with realistic market definitions of arms-length, selling price, produced coal and marketable condition could yield an independent set of rules that are synonymous with depletable income so as to use simple compliance methods and provide MMS with solid information that can be audited by MMS and other public or private interests.

The appropriate basis for federal coal royalty is gross proceeds of a mining company with absolutely no deductions. MMS is "giving away the store" when it proposes deductions such as washing, outbound transportation, Black Lung Excise Tax and Abandoned Mine Land Fees.

Taxes levied by states on mineral production are generally based upon the broad concept of causing mineral producers to pay for the privilege of producing, as compared to the relatively narrow concept of a royalty as being a share of production.

Even though a privilege tax lends itself more to gross proceeds administration than does a royalty, several states have departed from the taxation of absolute gross proceeds. For instance:

- Wyoming provides a deduction for all value added after the mine mouth, including the value of all processing or handling without regard to the type. Also, Wyoming allows gross proceeds to be reduced by total federal and state royalties for purposes of determining taxable value.
- Montana provides a deduction for state and federal production taxes in determining taxable value so as to prevent the compounding of severance tax upon itself and other production taxes. Montana also allows a deduction for the vast majority of federal, state royalties and Indian in arriving at taxable value.
- New Mexico reduces gross value by the amount of all government rents and royalties to arrive at severance tax value.

The logic espoused by some that deductions such as those allowed by the states for tax purposes are inappropriate as applied to the more narrow royalty concept escapes us. It would seem that if these ideas are valid in the calculation of ad valorem mineral taxes at the state level, they are even more valid in the calculation of ad valorem royalty value at the federal level. The apparent answer to this inconsistency is that it is much easier to promote maximized near term revenue without regard to logic or long term consequences when the program in question is administered by a federal agency. We strongly assert that consistency, efficient and fair administration are priorities that should precede revenue or political considerations.

Federal royalties can't be administered based upon a tax or accounting concept because current administrative personnel are not accounting oriented.

This may be a valid criticism to a degree. However, regardless of the methodology ultimately built into MMS regulations, the determination of royalty value is in fact an accounting exercise. Ultimately, if accurate ad valorem royalty administration results are to be achieved, those who do the work -- both compliance and administration -- must have financial accounting training to interpret financial accounting data, which is the only realistic source for revenue and cost information.

Royalty administration using the depletion based approach will be more expensive than using gross proceeds.

The Kentucky experience is the best evidence that this is, in fact, not the case. Administrative expense would only be increased if additional, accounting oriented personnel, were hired to administer the coal royalty program.

The intent is to administer the coal royalty program using the same personnel and concepts as have been applied in the past in the gas and oil royalty program.

This is an error in judgment that must be corrected if the coal royalty program is to succeed. The similarity between gas and oil on the one hand and coal on the other, ends with the fact that each is a fossil fuel and are substitutes for each other under certain circumstances. Coal royalty administrative personnel should not be gas and oil people; they should be accounting oriented administrators who are familiar with the unique nature of the coal business. As pointed out earlier, a coal royalty program could be effectively and efficiently administered with only a handful of people, if they are the right people.

Depletion based valuation can't be used for coal because gas and oil lessees will want the same thing.

The vast majority of gas and oil is produced and sold at a field or regional market price. In the short run, the cost of production is not a direct pass through as is generally the case with coal. Field pricing is the most efficient and appropriate benchmark for oil and gas royalty valuation because it is the most accurate reflection of market value and the most readily available information. Likewise, depletable income is the best starting point for coal royalty valuation because it is the best indication of market value and is the most readily available information.

As we have often stated, coal is not oil and gas. Coal is not produced in the same manner as oil and gas. Coal is not sold in the same manner as oil and gas. Coal is not transported in the same manner. The point is that coal is different and unique and should be treated accordingly.

Royalty compounding upon itself can't be eliminated for coal without doing the same thing for oil and gas.

Royalties are not generally directly transferred to oil and gas purchasers as a cost of reimbursement. Therefore the royalty does not normally compound upon itself in a oil and gas price as it does in a typical coal sale where the royalty is in fact directly and totally reimbursed in the vast majority of cases. For purposes of illustration, assume equal units of gas or oil and coal sold for $10.00 and a new 12.5% federal royalty is imposed. The following example illustrates the difference.

	One Unit of Gas/Oil	One Unit of Coal
Pre Royalty Selling Price	$ 10.00	$ 10.00
Fed. Royalty Price Increase ($10 @12.5%)		1.25
Compounded Royalty (12.5% of 12.5% to Infinity)		.18
Post Royalty Selling Price	$ 10.00	$ 11.43

The imposition of federal royalty on gas or oil becomes an additional cost. Price does not change until the prevailing field or market price changes.

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The imposition of federal royalty on gas or oil becomes an additional cost. Price does not change until the prevailing field or market price changes.

Under the provisions of most federal coal supply agreements, the federal royalty increases price as well as cost. Therefore, using the MMS gross proceeds concept, the increased price is subject to a royalty. Total federal coal royalty becomes $1.43 compared to $1.25 on the same gas/oil value unit, an effective 14.3% royalty on coal compared to 12.5% on gas/oil.

Deducting federal royalty to arrive at coal royalty value places coal on the same footing as gas and oil.

Because coal is not gas and oil and is not sold, produced, transported or priced like gas and oil, the difference in treatment is justified.

Additionally, we do not propose to argue the merits of the treatment of federal gas and oil producers. We would, however, make the comment that if gas and oil producers are paying excessive federal royalties due to compounding of the royalty upon itself or any other government tax or fee, excessively charging coal producers for the sake of consistency compounds rather than corrects the problem. If there are problems with gas and oil valuation, they should be independently evaluated and corrected. We submit that coal is so vastly different than gas and oil that royalty administration, of necessity, will be equally different if it is to be successful. Decreeing by regulation that coal is the same as gas and oil is like decreeing that the sun rises in the west. Regulations, even though they may have the force and effect of law, can't change reality.

The industry proposed fixed valuation point (defined point of first marketable condition) will deprive the government of revenue.

The concept of a royalty is not the same as the concept of a tax that raises revenue. A royalty is supposed to be a share of the mineral owned by the lessor. Once that mineral has been extracted and brought to marketable condition at no cost to the lessor, that lessor has no right to any value that is attributed to or added to that product after that point. MMS clearly indicates in its proposed regulation that royalty is due on coal that has achieved marketable condition without regard to whether it is actually sold. Using the same logic, it follows that once marketable condition has been achieved and royalty becomes a lien, it should not be increased by activities occurring after the point of attachment. To attempt to do so converts the concept of a royalty into a gross income tax.

We do not believe Congress intended federal royalty to be a gross income tax. We assert that the original concept of a royalty be adhered to by rigidly defining a physical point at which coal achieves marketable condition and determining value at that point, excluding any value added or subtracted subsequently. Since marketable condition of most federal coal is achieved after the coal has been crushed and sized, value should be determined at that point. It is inappropriate to attach liability at one point in the production process and measure value at another.

Long term coal supply agreements are pipelines through which revenues flow to coal companies and governmental units. Increases in that revenue stream through increased government levies is in the best interest of coal producers as well as governmental units.

This notion could not be more unrealistic. The preservation of long term coal supply agreements through prudent cost control, both by producers and lessors, is very much in the best interest of both. If direct government levies were a relatively minor part of the cost of coal, the impact of government policy making would not be significant. Unfortunately, this is not the case. With the application of a 12 1/2% federal coal royalty, the direct federal and state government generated portion of total coal cost can easily exceed 40%. Due to this nearly equal partnership, it is incumbent upon the government to exercise as much cost control prudence as does the lose. To the extent that long term coal supply contracts are aborted and lower prices result or alternative fuels are used, both the lessor and the lessee are major losers. It is, therefore, in the best interest of both not to take actions that promote such undesirable results.

The Industry Proposal is a "package" that must be accepted or rejected in total.

While we believe the industry proposal is much more closely aligned with legislative intent in terms of valuation and efficiency, the proposal is based upon three basic severable concepts which are:

- Depletable income as the valuation starting point;
- A fixed physical point of valuation;
- Valuation adjustments to convert producers' gross income into coal value.

As illustrated by the preceding summary, the basic parts of the proposal function independent of each other, and would do so even if all of the proposal is not accepted.

Government-Imposed taxes and fees, such as Black Lung Excise Tax, Abandoned Mine Land Fees and state severance taxes, are costs that should be "internalized" and, therefore, included in coal royalty value.

There are limitations on the relationship between cost and price. The universally-accepted ad valorem rule is that cost or price equal value only when determined by the action of a free market. If you apply this rule to coal royalty valuation, it is apparent that federal coal declines in value when direct taxes and fees are imposed.

In economic terms, if the price of a product increases without a corresponding increase in the quality or desirability of the product, the value drops. The amount of value decline may be a very subjective issue, but not the fact that the decline occurred. The industry proposal does not intend to remove the subjective decline in value that results from the imposition or increase in government levies. It simply proposes that such levies not be included in the value, because they in fact add nothing to it.

A good example of the price/value relationship can be seen in the following hypothetical case: If Washington, D.C. decided to impose a $500 annual fee for the privilege of driving a private motor vehicle in the city for very good and worthy public policy motives related to traffic congestion and pollution, the value of an individual's car would simultaneously decline in the marketplace. The car could be sold to someone who is not driving in Washington, D.C. for the same price as prior to the imposition of the tax, but the market has been severely limited. If the owner tries to sell the car to someone who will be driving in the city, they will be more resistant to the price and less willing to pay the full amount because their cost of operation has increased (to pay for a worthy social cost).

Government is in a totally unique position with respect to federally-owned coal as both landlord and public social policy maker. Great care should be taken to separate these two functions. If there is merit in the imposition of a Black Lung Excise Tax or a Reclamation Fee or anything else in the future, then so be it. It is really stretching the point, however, to say that such nonmarket-generated cost or price increases enhance the value of federal coal when, in fact, the opposite is really the case.

One could construct a scenario that says government levies that are truly user fees for government services should be internalized. However, the vast majority of the funds collected by federal and state levies have nothing to do with services provided for producers of federal coal. Most of the Abandoned Mine Land funds are directed to areas other than federal leases. The Black Lung Excise Tax is levied disproportionately upon federal coal when the incidence of black lung disease is negligible, both in the past and currently, from mining on federal leases as compared to other mining areas. Wyoming state and local severance tax, for instance, funds approximately 70% of the total state and local operating budgets. Obviously, the mineral industry is not consuming 70% of Wyoming's state and local government services. In fact, what these levies represent are subsidies for other parts of the economy or other geographic parts of the United States, and as such could not possibly be adding to the value of federal coal. The "internalizing" of these costs is contemplated by the policy-making side of our two-headed landlord, which we believe is poor public policy. The appropriate policy should be that each government levy stand independently on its own merits and not interact with all other such levies to generate revenues in excess of intent.

SUGGESTED LANGUAGE CHANGES

WITH ACCOMPANYING JUSTIFICATIONS

Sec. 206.250 - Purpose and Scope

We wish to note that MMS specifically focuses on the value of "all coal production" in subparagraph (a). We agree with this emphasis but believe MMS loses sight of this goal throughout the balance of the rules. We will highlight MMS's tendency to focus on other items besides "production" in our latter comments. Suffice it to say that we strongly support MMS's characterization of the purpose and scope of its authority and responsibility as set forth in subparagraph (a).

We also strongly endorse the statement in subparagraph (b) that if any of MMS's rules are inconsistent with the terms of a lease, the lease shall govern. It should be clarified in this section that a specific lease term governs if inconsistent with any provision in these regulations, notwithstanding a general provision in the lease that the lessee agrees to comply with applicable regulations.

We also note here that MMS should delineate and explain in the preamble to the final rules that coal must be allocated to each particular lease in the course of product valuation and royalty assessment. Any other approach would obviously result in inappropriate or inaccurate royalty assessments.

Sec. 206.251(b) - Definitions

Delete the definitions of "allowance," "coal washing allowance" and "transportation allowance" in subparagraph (b) in their entirety.

Insert the following definition where appropriate and reletter the subparagraphs in section 206.251 as necessary.

"Processing Allowance"

"Processing allowance" means the amount deductible from gross royalty value for any processes or handling applied after coal produced from a federal lease has achieved marketable condition, to the extent that such processes and handling are included in the definition of gross royalty value. The amount of processing allowance shall be determined pursuant to section 206.260.

Justification:

We assert that it is the value added by coal processing and/or handling activity that should be allowed by MMS as a deduction-- not just cost. In this way, the net royalty value will properly reflect only the value of coal at the point that it has reached marketable condition. Section 206.260 as proposed infra accomplishes this objective.

Sec. 206.251(d) - Definitions

Change to read as follows:

(d) "Arm's-length contract" means a contract or agreement between independent, nonaffiliated persons. For purposes of this subpart, two persons are affiliated if one person has actual control**[s]** over, is actually controlled by, or is under actual common control with another person as defined in Internal Revenue Service regulation section 1.613-4(j) in effect January 1987. **[or if one person owns an interest (regardless of how small), either directly or indirectly, in another person.]**

Justification:

We urge MMS to adopt a definition of ownership and control that is based on the concept of actual control. Such a definition is found in Internal Revenue Service (IRS) regulation section 1.613-4(j) which reads as follows:

"(j) Definition of controlled group. When used in this section --

(1) The term 'controlled' includes any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control

> arises if income or deductions have been arbitrarily shifted.
>
> (2) The term 'group' means the organizations, trades, or businesses owned or controlled by the same interests."

If the long established related party definition used by IRS works well for purposes of determining income subject to federal percentage depletion, it should work equally as well in determining income subject to federal royalty. The use of an established and tested definition would allow MMS to rely upon IRS arms-length determinations without the need for additional layers of administration.

The coal industry has also addressed these concepts recently in two different regulatory settings -- one before the Office of Surface Mining (OSM) and one before the Bureau of Land Management (BLM). Copies of those comments, which extensively discuss the concepts of ownership and control, have previously been submitted to MMS.

Any contract that qualified as an "arm's-length contract" as defined herein at the time the contract was entered into should continue to qualify as an "arm's-length contract" notwithstanding any subsequent affiliation between the parties to the contract so long as such contract has not been substantially amended after the date of such affiliation. We request that MMS clarify this point in the preamble to the final rules.

Sec. 206.251(j) - Definitions

Change to read as follows:

(j) "Contract" means any oral or written agreement, including amendments or revisions thereof, between two or more persons and enforceable by law. **[that with due consideration creates an obligation.]**

Justification:

We believe the last phrase of the proposed definition is unnecessary and confusing and should therefore be deleted.

Sec. 206.251(k) - Definitions

Change to read as follows:

Delete subparagraph (k) - "Gross proceeds (for royalty payment purposes)"; reletter the remaining paragraphs and add two new subparagraphs in the appropriate place as follows:

"Gross Royalty Value"

The "gross royalty value" of coal produced from a federal lease is synonymous with "gross income from the property" as defined in Internal Revenue Code section 613(c) and regulations 1.613-3 and 1.613-4 in effect January 1, 1987, reduced by an amount equal to all royalties paid or incurred by the lessee with respect to the lease in accordance with Internal Revenue Code section 613(a).

"Net Royalty Value"

"Net royalty value" (for royalty payment purposes) means gross royalty value attributable to a federal lease as defined in section 206.251, increased by amounts paid or incurred by the lessee for all royalties attributable to the federal lease, except federal royalties, and reduced by the processing allowance determined pursuant to section 206.260, federal black lung excise tax, abandoned mine lands fees and state and local taxes based on production attributable to coal produced from the lease.

Sec. 206.251(k) - Definitions cont'd

Justification:

We have articulated on several occasions our concerns with the definition of "gross proceeds." Over the course of time, we have seen the definition become more and more complicated and onerous. Both the coal mining and electric utility industries oppose and continue to oppose any MMS proposal to include within the definition of "gross proceeds" any severance tax, black lung or SMCRA fee, or royalty-on-royalty assessments, for the reason that the addition of such fees and assessments to the definition results in the payment of a royalty on a tax, which ultimately results in the imposition of a royalty considerably higher than the statutory rate as specified by FCLAA.

We certainly appreciate and support MMS's proposal to exclude the SMCRA and black lung assessments from the definition of gross proceeds, but must urge the state severance taxes and the royalty-on-royalty calculation also be excluded. Third party cost components are costs which are not established by a free market and do not contribute to the value of coal. There is no value added to federal coal as a result of these government impositions. To include them in the base for royalty calculation purposes is bad law and bad policy. In fact, a strong case can be made that directly imposed government taxes and fees depress the value of federal coal. While such a policy may create a revenue benefit to government in the short run, it artificially inflates the cost of federal coal in the marketplace making it a less desirable fuel choice. We, therefore, urge the MMS to give particular consideration to the issue of royalty-on-royalty. We would also note here that neither the Black Lung coal excise tax nor the Abandoned Mine Land fee are assessed upon themselves. In fact, 30 CFR Part 870 specifically prohibits the AML fee from being assessed upon itself, and IRC Section 4216 likewise prohibits the imposition of Black Lung Excise Tax upon itself. We urge the MMS to apply similar, reasonable logic here and delete this component from the royalty calculation.

As further justification for the exclusion of these taxes, we offer the following.

Coal companies pay a variety of ad valorem and excise taxes. These include property and severance taxes, and the federal excise necessary to fund the black lung and abandoned mine land programs. In many long-term coal sales contracts, these are passed on to the customer. The lessee receives no additional value from these payments, which are only related to the cost of the coal through the tax structure. In fact, by adding these taxes to the value of coal, the government is directly compounding government cost upon government cost and improperly inflating the royalty payment.

Sec. 206.251(k) - Definitions cont'd

The imposition of each tax, fee or royalty by any governmental unit should be on a "stand alone" basis. If there is justification for the imposition, so be it. However, none of these levys should be allowed to increase the others by virtue of their impact upon price. Cost or price increases caused by government action rather than a free market do not equal value. The relationship between government imposed cost increases and value, if any, is inverse.

The fallacy of the "gross proceeds" approach to coal valuation is aptly demonstrated by the inclusion of royalty reimbursements in the definition of gross proceeds. In many long-term coal contracts, the lessee's customer agrees to pay the royalty owed (whether private, state or Federal royalty) for the coal it purchases. Notwithstanding the clear language of its readjusted or newly issued Federal lease, the lessee will not pay the statutory royalty but a higher royalty that includes this arbitrarily imposed increment. Obviously, this is not the intention of the law. In effect, the government is charging a royalty on a royalty to infinity with the result that it is raising the royalty payable under the Federal leases for surface mines from 12.5% to 14.3% without following the proper procedure for lease readjustment or rulemaking in violation of the Administrative Procedure Act.

Sec. 206.251(k) - Definitions cont'd

In addition to our concerns regarding taxes, we also are strenuously opposed to the proposal insofar as it would include so-called take-or-pay payments in the gross proceeds definition when coal actually is not being produced or removed from the lease. If no coal is produced and sold, the lessor's property resource base and property value have not been diminished and no royalty should be due. The consequences of a so-called take-or-pay provision may be remedial (exclusive or non-exclusive), liquidated damages, optional performance, or a variety of other consequences depending upon the particular contract provision and the method of its operation within the contract. For example, take-or-pay coal supply agreement provisions are frequently designed to protect the producer from losses after it has invested perhaps in excess of $100 million in equipment, machinery, leases, manpower, etc. to construct a mine in order to perform its obligations under the coal supply agreements. If the lessor had participated in these enormous capital expenditures and thus is sharing in the financial risks of coal development, one might be able to understand why it would have the right to participate in the financial damages resulting from the inability to amortize such a large investment. However, inasmuch as MMS and the United States do not participate in any of the financial risks involved in opening and developing a coal mine, they have no equitable or legal right to participate in payments for the underutilization thereof, unless and until such payments are credited against the price of coal actually produced. It should be recognized that so-called take-or-pay amounts are often set to cover the lessee's carrying costs and nothing more.

We also object to this provision because if royalty were required to be paid in advance of production, as the regulations now are proposed, the lessee would not even be entitled to a credit from coal subsequently produced and would in some circumstance end up paying a double royalty to the Federal government. We address this issue further in these comments at Sec. 206.251(x), the definition of "take-or-payment."

The proposed regulations also would infer an increased gross proceeds to include reimbursement to a lessee for certain services, the costs of which ordinarily are the sole responsibility of a lessee. The coal industry recognizes that there may be a legitimate need to address this particular subject prospectively if new regulations are promulgated in the manner proposed; otherwise, an opportunity for abuse could occur and royalty payments could in some isolated instances partially be avoided by manipulation of contracts. However, we must urge in the strongest form possible that any such regulation, if promulgated, apply prospectively to subsequently executed contracts and not apply to existing contractual relationships, or amendments or revisions thereto.

Indeed, most, if not all of the contracts underlying the leases which require grandfather treatment, were negotiated and executed at a time when the underlying federal lease stipulated a cents-per-ton and not an ad valorem royalty payment. Clearly, under such circumstances, cost reimbursement to the federal coal lessee had no relationship to the cents-per-ton royalty rate, and neither party to the agreement (the federal coal lessee or the purchaser) could have possibly contemplated a penalty in the form of an increased royalty, at the time the lease was changed from a cents-per-ton to an ad valorem basis. To retroactively penalize the federal coal lessee and the federal coal purchaser who amend or revise such contracts after the MMS proposal becomes effective would be an arbitrary abuse of process and of doubtful validity.

The coal industry is rife with existing contractual relationships wherein the coal buyer has subleased a tract of land to the operator, currently may own a loadout facility, may be contributing water to the mine operation, or may own a crusher or something similar; however, these contracts are still arms-length contracts. It goes without saying, we believe, that when these contracts were negotiated and entered into, ad valorem royalty payment avoidance was not on either party's mind, either principally or secondarily. Indeed, as noted above, there is the high probability that most, if not all, of these contracts were negotiated at a time when the federal lease called for a cents-per-ton royalty. These transactions occurred in the ordinary business world as a result of factors that were totally and absolutely unrelated to royalties. If MMS now were to attempt to go back into these countless contractual arms-length relationships between buyers and sellers and somehow attempt to attribute a royalty to some of these facilities, services or benefits that have been or are being contributed by the buyer, it will create a major disruption, not only to lessees, but also to the various state public utility commissions and to the consumers themselves, which have relied upon these existing contractual relationships and amendments or revisions thereto for many, many years. As a result, we must urge you to "grandfather" these existing contracts and amendments or revisions thereto in their entirety.

We have carefully thought through the concept of "value" and believe adoption of a depletion based benchmark is reasonable, fair and statutorily supportable. Combined with a fixed definition of marketable condition as reflected in "net royalty value," this approach would avoid most of the pitfalls of the proposed "gross proceeds" definition and provide MMS with an appropriate, easily audited, statutorily authorized basis upon which to calculate royalties. Using depletion principles contained in the Internal Revenue Code as a starting point is a fair and reasonable manner to determine value without MMS replicating previous Internal Revenue Service efforts.

Sec. 206.251(k) - Definitions cont'd

The depletion based valuation concept is not unique or untested. The state of Kentucky has used this approach for many years to determine value for severance tax purposes with highly satisfactory results. Kentucky's severance tax statute reads as follows:

> KRS 143A.010. *** (5) "Gross value" is synonymous with gross income from property as defined in section 613(c) of the Internal Revenue Code and regulations 1.613-3 and 1.613-4 in effect on December 31, 1977, with the exception that in all instances transportation expense (whether or not by common carrier) incurred in transporting a natural resource shall not be considered as gross income from the property. Gross value is to be reported as follows: . . . . .

The advantages of the fixed valuation point calculation using the IRC 613(c) federal depletion benchmark are summarized as follows:

1. Greatly reduce and simplify MMS administrative procedures and costs because valuation would be based upon a well-defined and universally available benchmark that is easily verified with a minimum of effort.

Sec. 206.251(k) - Definitions cont'd

2. Substantially reduce and simplify coal producer compliance work in that a simple mechanical calculation would be all that is necessary to remit royalties.

3. Royalty liability, most of which is ultimately paid by electric utility consumers would be a determinable amount not subject to major, unexpected fluctuations and audit changes.

4. Eliminate the arguments over what is and is not an arms-length contract because IRC 613 arms-length determinations are based upon the long standing, well-defined definition of a controlled group which is used as the basis for arms-length determinations. Since this definition works for the Internal Revenue Service for federal percentage depletion purposes, it should work equally well for MMS and the coal industry for federal royalty purposes.

5. The calculation would be self-policing in that it would be in the coal producer's best interest to maximize "gross income from mining" for depletion purposes, thus maximizing federal royalties. This would be so even though the depletion rate is less than the current 12.5% royalty rate for surface mines because, in the vast majority of cases, the royalty

is reimbursed by the electric utilities while the depletion accrues to the benefit of coal producers.

6. Eliminate the so-called "take-or-pay" issue because payments for under utilized mine facilities are excluded from the depletion base because they are not related to the ownership, mining or production of the mineral.

7. Eliminate the offensive practice of applying federal royalty upon itself because royalties are not included in the depletion base.

8. Eliminate the effort to impose royalty on value added by new coal technologies and processes such as liquifaction, gasification and thermal drying. Such activities are deemed by IRS to be refining processes not being related to mining and production of the basic mineral and, therefore, not subject to depletion.

The advantages in terms of predictability, administration and fairness are exceedingly obvious. The result would be a smoothly operated royalty program which would be in everyone's best interest.

Sec. 206.251(n) - Definitions

Change to read as follows:

Delete the proposed definition of "lease" in subparagraph (n) and substitute the following:

> (n) "Lease" means a Federal lease, issued under the coal leasing provisions of the mineral leasing laws, which grants the exclusive right to extract coal.

Justification:

We fail to see the necessity to define the term "lease", as it is a well understood term of art. However, if MMS feels compelled to do so, we suggest the above definition be used. It is taken from 43 CFR 3400.0-5(r). The proposed definition is much too broad and we see no reason to have two different definitions for the same instrument within the same Department. Also, if MMS feels there is a need to account for Indian leases, it should do so separately and in a similarly limited fashion.

Sec. 206.251(o) - Definitions

Change to read as follows:

(o) "Lessee" means any person to whom the United States, an Indian Tribe, or an Indian allottee issues a lease. **[and any person who has assumed an obligation to make royalty or other payments required by the lease. This includes all persons who have an interest in a lease as well as an operator or other payor who has no interest in the lease but who has assumed the royalty payment responsibility.]**

Justification:

This is also a term of art and thus requires no definition. However, if MMS desires to define the term, it should delete the indicated language as being too broad in nature and subject to misconception. It could, for instance, include as a "lessee" a coal buyer who in the coal sales contract agrees to reimburse the coal miner for royalties payable.

Sec. 206.251(q) - Definitions

Delete the proposed definition of "marketable condition" and insert in lieu thereof the following:

(q) "Marketable condition" means coal which has undergone the processes of extraction, and, where necessary, crushing and screening.

Justification:

This definition has been amended to comport with our suggested definitions of "gross royalty value," "net royalty value" and "processing allowance" found in 206.251 as well as our revised standards for point of royalty determination (206.257).

Under our proposal, coal is in a "marketable condition" when it has been extracted, then crushed and screened. It does not require further "processing" before being considered marketable. At the first point of marketability, it then has value and a royalty may be determined. When further processing or handling takes place, an allowance (of 100%) should be provided.

Sec. 206.251(s) - Definitions

Change to read as follows:

(s) "Net-back method" means a procedure for valuing coal **[at the lease or mine when a sale has taken place]** downstream from the lease or mine **[. The procedure involves]** working back from the **[sales]** point of gross royalty value determination to arrive at **[the]** net royalty value **[of measurement]** at the first point of marketable condition. **[for royalty purposes. Consideration is given to costs incurred in the transportation, handling, washing, etc., necessary to get the coal to the point of sale.]**

Justification:

These suggested revisions will make the definition consistent with the proposed definitions of "gross royalty value" and "net royalty value".

Sec. 206.251(t) - Definitions

Change to read as follows:

(t) "Net output" means the quantity of **[washed]** coal **[that a washing plant produces.]** delivered to the purchaser.

Justification:

These revisions have been suggested to make the definition more accurate and readable.

Sec. 206.251(u) - Definitions

Change to read as follows:

(u) "Person" means any individual, [**firm, corporation, association, partnership, consortium, or joint venture.**] or legal entity.

Justification:

This revision is intended to make the definition legally sound, less confusing and less subject to being misconstrued.

Sec. 206.251(v) - Definitions

Subparagraph (v) - "Selling arrangement"

We are uncertain of what MMS intends by the term "selling arrangement" or how the agency intends to use it. Without more, the definition should be deleted.

Sec. 206.251(w) - Definitions

Change to read as follows:

(w) "Spot sales agreement" means any sales transaction where **[planned or]** actual deliveries span a short period of time, usually not exceeding one year.

Justification:

The term "planned" is not appropriate in the context of this definition or these rules.

Sec. 206.251(x) - Definitions

Subparagraph (x) "Take-or-payment"

We strongly urge MMS to delete this definition in its entirety.

Justification:

This definition includes in "gross proceeds (subject to royalties)" all so called "take-or-pay" payments even though no coal is produced from the lease and regardless of whether any portion of such payment is ultimately recoupable under the terms of the sales contract in question. Royalty should be payable only after coal is severed from the ground.

The major expenses associated with the production of coal are (a) the massive capital required to construct and operate the mine and (b) the large complement of trained personnel required to produce the coal. When opening a new mine, the operator will generally require assurance that it will achieve a satisfactory return on this significant investment in order to obtain reasonable financing and justify the expenditure. On the other hand, many utilities are not convinced that they can accurately predict the long term demand curve for their customer base. In this situation the parties may fashion an agreement that preserves the capital base for the operator while providing the utility with a high degree of flexibility. Typically, the utility must pay for this flexibility. The true capacity charge ("take-or-pay") will not provide any credit against the ultimate production of coal, which will be priced under the routine provisions of the contract. In this situation, the utility has not prepaid for any of the government's coal and we strongly assert that the government has no right to share in the risk of the capital investment.

The proposed regulations fail to recognize that both the lessor and the lessee benefit by producing coal, notwithstanding payments made by a coal buyer that are not shared with the lessor and that constitute damages. The coal company maximizes its investment in its mine by maintaining a stable work force and having the ability to take advantage of marginal and spot sales opportunities that would not alone justify the opening of a mine. Such payments may compensate for depreciation and capital costs associated with idle equipment.

As demonstrated, the inclusion of any so-called "take-or-pay" payment in the definition of "gross proceeds" misinterprets the economic reality of the payment. In addition, the proposed rules may be legally invalid as demonstrated by comments submitted on the prior draft of these rules. In those comments it was noted:

The statutory authority to include in production royalties payments made on "take-or-pay" provisions as if they were "advance royalties" is certainly subject to question. The authority governing the payment of "advance royalties" is found in the Mineral Lands Leasing Act (30 U.S.C. 207) as amended in 1976. Specifically, section 207(b) states that: 'The Secretary of Interior, upon determining that the public interest will be served thereby, may suspend the condition of continued operation upon the payment of advance royalities. Such advance royalties shall be not less than the production royalty.... The aggregate number of years during the period of any lease for which advance royalties *may be accepted in lieu of the condition of continued operation* shall not exceed ten.' Regulations promulgated pursuant to the Act specifically define advance royalties as 'the payment under a Federal lease in advance of actual production when authorized by the District Mining Supervisor, *to be made in lieu of continued operation*.' (30 C.F.R. 211.2(a)(1)) Section 211.23(a) states further that, 'advance royalty *may only be* accepted in lieu of continued operation upon application to, and approval by, the District Mining Supervisor.' (Emphasis added.)

> In addition, section 6 of the BLM's coal lease states that 'production royalties paid for a calendar month shall be reduced by the amount of any advance royalties paid under this lease to the extent that such advance royalties have not been used to reduce production royalties in a previous month.' Since advance royalties can only be accepted in lieu of continued operation--one percent of commercial quantities of recoverable coal reserves (30 C.F.R. 211.2(a)(7)(9))--if an operator is producing the required one percent, section 6 would prohibit the lessee from reducing his production royalty payment by the amount of his 'take-or-pay' payment, since these payments are not, by statute, considered 'advance royalties.'

We would also note here that the IRS has ruled with regard to so-called take-or-pay payments that they are not subject to the Black Lung tax. See IRS National Office Technical Advice Memorandum dated January 31, 1980. This is further evidence of the applicability of the IRS rulings and procedures to the royalty valuation rules.

Sec. 206.251(x) - Definitions cont'd.

It is clear from other portions of the proposed rules that royalty would be chargeable on any consideration received by a lessee for the production of coal. Thus, if payments, including so-called 'take-or-pay' payments are credited against future sales to the coal buyer, they would be includable for royalty purposes but only when the coal is produced and sold to that buyer.

In this context, we believe that the definition of the term take-or-payment should be deleted.

Sec. 206.253(d) - General royalty management responsibilties of MMS

Change to read as follows:

(d) When necessary, **[obtain]** examine copies of lessee contracts (including contract updates and amendments), sales agreements, coal **[washing]** processing agreements....

Justification:

See our comments at section 206.263, *infra*.

Sec. 206.253(g) - General royalty management responsibilities of MMS

Change to read as follows:

(g) Audit the records of lessee within 3 years from the date each royalty payment is due to determine that royalties have been paid properly to the Federal Government and Indian lessors.

Justification:

This section has been changed to accord with the requirements of 48 CFR 52.215-2(d), which provides for maintaining records for only three years.

The preamble indicates that lessees would be required to keep records supporting their royalty calculations for six years from the date of payment and would presumably be subject to audit during this time. We believe the audit period/record retention period should be more limited than proposed. General custom and practice in the business world limits audit rights to 2 or 3 years from the completion of a contract or specific action. We believe that government contracting practice limits audit rights to 3 years as well.

Federal acquisition regulations provide that the contractor shall make available at its office pertinent books and records for examination for 3 years. (*See* 48 C.F.R. 52.215-

Sec. 206.253(g) - General royalty management responsibilities of MMS cont'd

2(d).) We urge the department to revise this proposal to be more in line with standard industry practices on audit rights.

If MMS accepts our proposal that depletable income (gross income from the property) for federal percentage depletion purposes be used as the primary benchmark for determining royalty value, the auditing function would be greatly simplified. An audit would primarily involve making sure the royalty reports match the depletion schedule from the federal income tax return, and determining if IRS has taken exception to the calculation. We see no reason why such audits could not be conducted within three years.

Sec. 206.254 - General royalty obligations of the lessee

Change to read as follows:

The lessee is required among other things to:

[(a) Properly handle and protect coal;

(b) Place coal in marketable condition at no cost to the lessor]

(c) Accurately measure production. **[properly maintain it in inventory, and dispose of it in a manner beneficial to the public or Indian tribe's or allottee's interest.]**

(d) Maintain accurate records of production and sales[;] for a period of three years following the date each royalty payment is due.

(e) Maintain copies of all contracts, sales agreements, **[washing]** processing or transportation agreements, and other records that support the prices, costs and values used in valuing coal for royalty purposes. Copies of ~~these con~~tracts, etc., are to be made available to MMS **[either]** in the lessee's office during normal office hours. **[or provided to MMS in accordance with this Part at such time requested by the Department of the Interior.]**

Sec. 206.254 - General royalty obligations of the lessee cont'd.

(f) Make timely rental and royalty payments;

(g) Make timely reports on production and sales quantities **[and qualities; and]**

[(h) Properly value production and correctly pay royalties.]

Justification:

Subparagraph (a) should be deleted as it is an implied covenant and therefore a part of every lease.

Subparagraph (b) and portions of subparagraph (c) should be deleted as they impose new obligations on existing leases and on lessees beyond those that are required under law. Furthermore, these provisions assume that coal operators attempt to maliciously deceive our customers and the general public from whom we lease federal coal. We strenuously object to this underlying assumption and urge MMS to adopt our suggested revisions.

Subparagraph (d) should be changed to accord with the requirements of 48 CFR 52.215-2(d), which provides for maintaining records for only three years.

Subparagraph (h) should be deleted because it is superfluous and misleading. Its requirements are already covered adequately by subparagraph (f).

Sec. 206.254 - General royalty obligations of the lessee cont'd.

Subparagraph (g) has been amended for reasons discussed at section 206.256, infra.

Note: Subparagraphs should be relettered to account for the deleted paragraphs.

Sec. 206.255(a) -- Coal subject to royalties - general provisions

Change to read as follows:

> (a) All coal **[(except coal unavoidably lost as determined by BLM pursuant to 43 C.F.R. Group 3400)]** produced pursuant to an approved resource recovery and protection plan and sold from a Federal or Indian lease subject to this Part is subject to royalty. This includes coal used by the lessee on lease or off lease.

Justification:

This revision has been made to more accurately and properly reflect current practices concerning royalty payments. Also we believe it is helpful to reference the BLM-approved mining plan as the governing document on questions of maximum economic recovery, unavoidable coal loss, etc.

Sec. 206.255(b) - Coal subject to royalties - general provisions

Change to read as follows:

(b) If a lessee receives compensation for unavoidably lost coal through insurance coverage or other arrangements, royalties at the rate specified in the lease are to be paid on the amount of compensation which is received for the coal lost.

Justification:

We request that MMS more clearly articulate the purpose and scope of subparagraph (b). MMS appears to be attempting to reach certain types of insurance proceeds but we are unclear as to exactly what types. For instance, what if a silo explodes and the lessee is compensated? Does MMS anticipate levying a royalty on the compensation? If so, on what -- the coal, the silo or both? What if a dragline falls into a pit and a lessee is compensated for lost production -- is a royalty due and owing?

If subparagraph (b) is another "gross proceeds" concept, then we urge MMS to strike it. In any event, we request a more precise explanation of the provision.

Note: With regard to subparagraph (c), we should note that the recordkeeping requirements for allocation and the maintenance of such records may be difficult since the "event" at issue may have occurred 10-12 years in the past.

Sec. 206.256 - Quality and quantity measurement standards for reporting and paying royalties

Delete subparagraph (a) regarding reporting of coal quality information.

Justification:

We object to being required to submit quality information, as we see no legitimate governmental interest or necessity in receiving this information, particularly if the coal is being sold pursuant to a bona fide arms-length coal supply agreement. Federal coal royalties are calculated on quantity and price. Coal quality data, while certainly a factor in determining price, should not be a requirement for submission, particularly if a bona fide arms-length transaction can be verified. If MMS feels it necessary to obtain such information, we would urge the agency to seek it from BLM.

Sec. 206.257 - Point of royalty determination

Change to read as follows:

(a) For all leases subject to this subpart, royalty shall be computed at the earlier of the point when **[on the basis of the quantity and quality of]** coal **[in marketable condition at the point of royalty measurement prescribed by BLM]** is produced and first placed in a marketable condition or loaded for delivery.

(b) Coal produced and added to stockpiles or inventory does not require payment of royalty until such coal is later sold or otherwise **[disposed of]** consumed. **[MMS may ask BLM or BIA to increase the lease bond to protect the lessor's interest when stockpiles or inventory become excessive as determined by BLM.]**

(c) The lessee shall pay royalty at a rate specified in the lease at the time the coal is sold or **[otherwise disposed of]** consumed unless otherwise provided for at 30 CFR 206.258(d).

Justification:

Subparagraph (a) should be amended to more appropriately reflect the actual point of royalty determination. Given our comments on section 206.256(a), the only appropriate measurement is when the coal has been "produced", for without production no royalty can attach. Finally, we assert that once the coal is placed in a marketable condition (as defined in section 206.251(q)), the royalty may be determined. It is these two essential conditions--production and marketable condition--that provide the basis for royalty determination. At that point, MMS should then look to the proposed depletion based valuation procedure as defined at section 206.259.

Subparagraph (b) states that MMS may ask BLM to increase the lease bond when stockpiles or inventory become "excessive." We would urge MMS to recognize an element of flexibility in these determinations since a 100,000-ton stockpile may be "excessive" at one operation but may be quite normal at another. In other words, a numbers-oriented approach specifying cut-off points for bond increase determinations would be wholly inappropriate.

We believe that to the extent the language in subparagraph (c) calls for payment at the time that coal is sold that it is a correct interpretation of the lessee's obligation to the lessor and will provide for the proper royalty payment. However, to the extent that it calls for payment at the time that lessee receives an advance payment as described in proposed Section 206.251(k), then the government is receiving money to which it is not yet entitled.

Sec. 206.257 - Point of royalty determination cont'd.

Any advance payments that are later credited against subsequent production for a particular buyer under a given contract should be subject to royalty. The issue is the point in time at which royalty is due. The advance payments may be structured so that while recoupable against ultimate purchases by lessee's customer, lessee's customer may not be under an obligation to purchase the volume represented by those advance payments. Thus, there will be no way of determining the payment for any part of the tonnage in question. At the time of recoupment, the government should be entitled to collect royalties on the entire price of whatever quantity of coal is ultimately purchased before application of any credit. If the customer purchases no coal then no royalty is due because there has been no coal production.

As a final point, we are unclear as to the meaning of the words "or otherwise disposed of," in this section and are recommending alternate language.

Sec. 206.258 - Valuation for cents-per-ton leases

Change to read as follows:

(b) The royalty for coal produced from leases subject to this section shall be based on the dollar rate per ton prescribed in the lease. That dollar rate shall be applicable to the actual volume of coal sold or used, **[including coal which is avoidably lost as determined by BLM pursuant to 43 CFR Group 3400]**.

[(c) For leases subject to this section, there shall be no allowances for transportation, removal of impurities, coal washing or any other processing or preparation of the coal.]

Justification:

We are concerned with the requirement that royalties be paid on coal avoidably lost. This proposed regulation does not take into consideration the realities of the operating or business world. Every operating federal coal lessee routinely encounters situations in which for one reason or another it does not mine coal that technologically is capable of being mined. For example, the lessee actually may find itself unable to market a particular coal seam that contains coal that is higher sulfur, lower Btu, etc., even though the technology exists to market that seam and perhaps a market theoretically might exist for it elsewhere. Would a royalty be attributable to such a seam that is not mined?

Sec. 206.258 - Valuation for cents-per-ton cont'd.

Similarly, if an operator leaves the bottom or the top six inches or foot of a seam in its coal removal operations, would a royalty be attributable to that coal? These and similar questions would appear to be answered in the affirmative under these proposed regulations. We wish to point out that this proposal would result in unnecessary, duplicate regulation by the Department of Interior in that BLM already has existing authority to assure maximum economic recovery ("MER") of the federal coal reserve under the operator's resource recovery and protection plan. These questions are properly addressed under the subject of MER and not in royatlty regulations, which should be limited to payments for coal actually mined.

We would note with regard to the discussion of lease readjustments in subparagraph (d) that this entire area is in such a state of turmoil that MMS should probably refrain from addressing this issue at this time. Furthermore, this regulatory issue is being reviewed and is the responsibility of BLM. Several cases are pending before a variety of U.S. federal courts and before the Interior Board of Land Appeals. Under the circumstances, MMS should await resolution of the myriad issues attending readjustment by BLM rather than create additional conflicts or questions.

Also, with regard to the 30-day requirement in subparagraph (d), we would note that in some cases the lease terms may prescribe something different and those terms should govern.

Sec. 206.258 - Valuation for cents-per-ton leases cont'd.

This proposition ("lease terms govern") should be constant throughout the rules.

Sec. 206.259 - Valuation standards for ad valorem leases

Change to read as follows:

(a) This section is applicable to coal leases on Federal, Indian Tribal, and allotted Indian lands (except leases on the Osage Indian Reservation), which provide for the determination of royalty as a percentage of the value of production (ad valorem). The value for royalty purposes of coal produc**[tion]** ed and sold from such leases or consumed shall be the net royalty value of coal as defined in **[determined pursuant to]** section 206.251. **[paragraph (b) or (c) of this section, less applicable coal washing allowances and transportation allowances determined pursuant to Section 206.260 and 206.262.]**

Justification:

Once again, the crucial criteria for determining when to value coal for royalty purposes is after it has been produced and sold. Our revisions reflect this fact.

Sec. 206.259(b), (c) and (d) - Valuation standards for ad valorem leases

Delete subsections (b), (c) and (d) in their entirety. Add the following language and reletter the subparagraphs that follow accordingly.

If there is a sale of coal under a non-arm's length contract, or other disposition other than by arm's length contract, the criteria for determining gross royalty value shall be as prescribed in Treasury regulation 1.613-4(b)(2), based on a representative market or field price method.

Justification:

Subparagraph (b) has been deleted as it is unnecessary under our suggested approach.

Subparagraph (c) should be deleted and the above suggested language inserted. The suggested language is similar to the IRS depletion based approach for arm's length contracts and would provide for a single coordinated approach to royalty valuation.

Additionally, the suggested language has been used by the mining industry and the government over many years and has survived judicial scrutiny and received interpretation by the courts.

Finally, our suggested approach, referring as it does to IRS regulation 1.613-4, would assure consistency in valuation between arm's length and non-arm's length transactions.

Sec. 206.259(b), (c) and (d) - Valuation standards for ad valorem leases cont'd

Given the changes in subsections (b) and (c), subsection (d) should also be deleted. However, if the benchmark system is reinstated by MMS for non-arm's length contracts, we believe it is essential by all standards of fairness and appropriate administrative procedure, to provide for an adjudicatory hearing on any MMS determinations pursuant to 5 U.S.C. 544.

We suggest the following language be used in this event:

Presumptions and hearings

Notwithstanding any other provisions in this Subpart, the determination of the lessee as to the (1) point of royalty determination, (2) valuation standards for ad valorem leases, and (3) processing allowance shall be presumptively valid. After such determination by the lessee, the burden of proof shall shift to BLM, the MMS/Director, the Associate Director for Royalty Management, or their delegees, as the case may be, to establish, by a preponderance of the evidence, and after a full adjudicatory hearing under 5 U.S.C. Sec. 554 that the lessee's determination is incorrect.

Industry submits that it is the entity most knowledgeable concerning coal valuation and allowance issues, and its determinations should be given presumptive weight. The present appeal

Sec. 206.259(b), (c) and (d) - Valuation standards for ad valorem leases cont'd

procedure is inadequate, since it does not mandate an oral hearing at which determinations by BLM and/or MMS staffers and officials can be probed and tested through cross-examination at an oral hearing before a qualified fact-finder. The industry's proposal would remedy this inadequacy.

In accordance with this additional language, MMS should strike all references in those sections in the proposed rule that refer to findings or determinations of BLM, the MMS/Director, the Associate Director for Royalty Management, or their delegees, with reference, as the case may be, to point of royalty determination, valuation standards for ad valorem leases, processing allowances and transportation allowances.

Sec. 206.259(e) - Valuation standards for ad valorem leases

Delete subsection (e) in its entirety

Justification:

This provision assumes that the "prudent operator" must resolve every contractual issue with its customer in a manner that benefits the royalty holder, regardless of the resulting impact on the lessee's contractual relationship with its customer. This provision may effectively prohibit compromise and negotiation between the lessee and its coal customers (usually electric generating utilities) without prior governmental approval. Although the regulation does not specifically require governmental approval, the coal company assumes substantial financial risk for failure to obtain such an approval prior to paying a lower royalty to the government. We believe that the assumption in this provision represents a substantial departure from the actual obligations of the prudent operator. In this period of low market value for coal, this provision will further strain the already awkward relationship between utilities, which are being forced by their state commissions to hold down costs and protect consumers, and coal companies, which are struggling to maintain viability in the face of the market hovering at the bottom.

As recognized in the introduction to the regulations, the coal company has every incentive to maximize its return on investment in an arm's-length transaction.

Sec. 206.259(e) - Valuation standards for ad valorem leases cont'd.

The basic premise underlying this methodology is that value is best determined by the interaction of competing market forces--the 7/8ths or 4/5ths owner is going to negotiate the best deal he can to further his own interests, advancing those of the royalty owner as well. This would add certainty to the market place and assure maximum, long-term revenues to all parties concerned. 52 Fed. Reg. at 1841.

The typical coal sales contract negotiated during the 1970s and early 1980s was for a long term (anywhere from 10 to 30 years) and for a high volume. After many of these contracts were executed, the coal industry experienced unanticipated slowdown in demand and oversupply of competing coal. In this atmosphere, the market price of coal has tumbled. Coal companies have been attempting to hold the line on their contracts in order to realize the value of those contracts including the payback of their initial capital investment, which did not decrease with the drop in the market. Many of these contracts have been subject to contractual price reopeners while others were renegotiated as the result of continuing discussions with utilities.

Given the complexity of many long-term coal supply agreements, questions frequently arise as to the proper interpretation of various of the provisions. This is particularly true in the current economic climate, with the result that the coal company and its utility customer will continue to engage in a running

Sec. 206.259(e) - Valuation standards for ad valorem leases cont'd.

dialogue with respect to contract adjustments and operating considerations. In those cases where the proper interpretation may not be clear, the prudent operator will use its best efforts in working with its customer to find that interpretations in recouping its capital investment.

The prudent operator will use its discretion in balancing its interpretation of the contract with the preservation of the long-term customer relationship. We have found no law to the contrary. To the extent that this provision requires governmental intrusion into contract interpretation and renegotiation, we believe that it is inappropriate and not in keeping with the proper legal relationship between the lessor and the lessee/ prudent operator.

Under established law, the prudent operator has an obligation to operate the mineral lease in a manner that is profitable to itself yet considers the needs of the lessor.

Whatever in the circumstances would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required. Brewster v. Lanyon Zinc Co., 140 F. 801,814 (8th Cir. 1905).

Sec. 206.259(e) - Valuation standards for ad valoreum leases cont'd.

Thus, it cannot negotiate a sales contract in a way that is harmful to the lessor simply to achieve a benefit to other leases that it holds. 4 American Law of Mining, sec 132.04. On the other hand, the law is clear that the "prudent operator" standard does not require total "selflessness" on the part of the lessee. The law recognizes and expects that the prime motivation of the lessee is to attain a profit in its operations. 2 Eastern Min. L. Found. sec. 16.02(4), n. 27. In an arm's-length transaction a coal company's prime motivation in maintaining the long-term relationship by granting short-term concessions or agreeing to less favorable contract interpretations in recouping its capital investment.

We recognize that in a coal or mineral lease, the lessee/ prudent operator is under an implied convenant to market the coal in good faith. That convenant has been interpreted to mean that the prudent operator may have the obligation to exercise due care and reasonable diligence to attain the highest market price for the product. Kerr-McGee Corp. v. Bokum Corp., 453 F2d 1067 (10th Cir. 1972). However, as in the Kerr-McGee case, this obligation can be negotiated by the language of the leases themselves. Further, in the absence of bad faith on the part of the lessee, this obligation does not change the actual royalty payable under the lease as the government attempts to accomplish under the proposed regulations. In the case of Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957,973 (S.D. Miss. 1982), rev'd on other grounds, 726 F. 2d 225 (5th Cir. 1984), rehearing denied, 750 F2d 69, cert. denied, 471 U.S. 1005 (1985), the court agreed with Shell's position that

> In the absence of proof of failure by lessee to market gas with the diligence of a reasonable prudent operator, there are no judicial decisions requiring that payment of royalty under 'amount realized' royalty provisions be based upon any standard other than the amount actually realized by the lessee.

A prudent operator does not necessarily violate its obligation to a royalty owner by agreeing to less than the highest possible price for its product. In the case of Parker v. TXO Production Corp., 716 S.W. 2d 644 (Tex. Civ. App. - Corpus Christi, 1986) the Texas Court of Appeals held that the Texas Oil and Gas Corporation did not breach its implied covenant to market by agreeing to a price that was 5% less than a price available from other purchasers. The 5% represented a compression charge from the oil company's subsidiary, which was also the purchaser. The court held that the agreement to take the lower price was not conclusive as to breach of the covenant and that other factors would be considered before making such a determination.

Sec. 206.259(e) - Valuation standards for ad valorem leases cont'd.

The oil company based its decision on the size of its subsidiary, its reputation for handling large amounts of gas and the potential enhancement anticipated from the compression. The court referenced a prior Texas Supreme Court case in holding that "other factors facing the operator at the time of his decision besides price should be considered in implied covenant cases." 716 S.W. 2d at 647. The proposed regulations make adherence to price the only issue.

Finally, we have not found a case that holds that once having diligently marketed coal from a lease, the prudent operator cannot either (a) grant a concession without a formal amendment or (b) refrain from aggressive prosecution of every potential claim against its purchasers when discretion seems the better part of valor. The regulations presume that either of the above constitutes failure on the part of the prudent operator to perform in good faith. We believe that the Federal government should not undertake this significant departure from principles established by state law.

In summary, MMS appears to be saying one thing in their preamble regarding the objective of these rules and something quite different in the rules themselves. On page 1841 of the preamble, MMS specifically states that: "The basic premise underlying this methodology is that value is best determined by the interaction of competing market forces--the 7/8ths or 4/5ths owner is going to negotiate the best deal he can to further his own interests, advancing those of the royalty owner as well." We endorse this statement and believe it reflects the real world of contract negotiation and administration.

Subparagraph (e) on the other hand would substitute another methodology for the normal operation of contracts. It would impede the typical course of contract development and administration. MMS must understand that in the give-and-take of daily contract administration, it is simply infeasible to commit every contract adjustment to writing as a formal contract amendment. Additionally, subparagraph (e) evidences MMS's clear intent to obtain the maximum royalty possible to the complete disregard of "competing" market forces. We must object to this entire approach.

Sec. 206.259(f) - Valuation standards for ad valorem leases

Delete subsection (f) in its entirety.

Justification:

See our comments at section 206.251(x), definition of "take-or-payment," regarding our justification for deleting this section.

See our comments at section 206.259(b) regarding "which could accrue."

Sec. 206.259(g) - Valuation standards for ad valorem leases

Change to read as follows:

(g) **[The lessee is required to place coal in marketable condition at no cost to the Federal Government or Indian lessor.]**

Where the net royalty value established pursuant to this section is determined by a lessee's **[gross proceeds]** gross royalty value, that value shall be increased to the extent that it is understated **[the gross proceeds has been reduced]** because the purchaser, or any other person, is providing certain services, the cost of which ordinarily is the responsibility of the lessee, to place the coal in marketable condition. Any contractual arrangements or amendments or revisions thereto regarding services between the lessee and purchaser that are in effect at the time of promulgation of these rules shall not affect value determination.

Justification:

The first sentence in subparagraph (g) is inaccurate and has been deleted. See our comments on marketable condition, supra.

We have added language that is intended to assure that the application of this requirement is prospective in nature. If the

Sec. 206.259(g) - Valuation standards for ad valorem leases cont'd.

requirement is retroactive, it could result in litigation between a lessee and its customer concerning services provided to the lessee by the customer. Furthermore, the requirement, if retroactivity applied, could result in the altering of our existing buiness relationships. MMS states in the preamble that it does not intend to accomplish this result.

Sec. 206.259(i) - Valuation standards for ad valorem leases

Change to read as follows:

(i) **[Certain]** Any information **[submitted]** provided **[to MMS to support valuation proposals, including transportation and/or processing allowances, is]** pursuant to this subpart shall be exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 522. . . .

Justification:

We have amended this provision to broaden its application to all information.

Sec. 206.260 - Processing allowance

Delete all of section 206.260 and insert the following in lieu thereof:

Processing Allowance - Calculation

If the gross royalty value of coal produced from a federal lease as defined in section 206.251 includes amounts generated by processes or handling applied after the coal has achieved marketable condition as defined in section 206.251, such amounts shall be deducted as a processing allowance in arriving at net royalty value. The processing allowance shall be calculated using the "net back method" as defined at section 206.251 by multiplying gross royalty value by a fraction, the numerator of which is the cost of all post marketable condition processes and handling and the denominator of which is the total costs of all pre and post marketable condition processes and handling. The computation may be illustrated by the following equation:

$$\text{Gross Royalty Value} \times \frac{\text{Post Marketable Condition Costs}}{\text{Total Costs}} = \text{Processing Allowance}$$

Sec. 206.260 - Processing allowance

Justification:

Use of the proposed apportionment method of calculating a processing deduction rather than the complex and inadequate concept proposed by MMS has several advantages which are summarized as follows:

1. The calculation is simple, based on available information and easily audited.
2. This method has been used by other federal and state agencies (including IRS) with satisfactory results.
3. The potential for excessive deductions, which prompted MMS to propose 50% and 75% limits, would be eliminated because the calculation is based on the selling price rather than an unrelated basis as proposed by MMS.
4. The resulting deduction would be fair for both the lessor and lessee.

Sec. 206.261 - Allocation of [washed] **processed** **coal**

(a) When coal is subjected to a **[washing]** processing allowance, the **[washed]** processed coal must be allocated to the leases from which it was produced.

(b) When the net output of coal from a **[washing plant]** processing facility is derived from coal obtained from only one lease, the quantity of **[washed]** processed coal allocable to the lease will be based on the net output of the **[washing plant]** processing facility.

(c) When the net output of coal from a **[washing plant]** processing facility is derived from coal obtained from more than one lease, the quantity of net output of **[washed]** processed coal allocable to each lease will be based on the ratio of measured quantities of coal delivered to the **[washing plant]** processing facility and washed from each lease compared to the total measured quantities of coal delievered to the **[washing plant and washed]** processing facility and processed.

Justification:

These changes have been made to be consistent with our earlier revisions regarding use of the term "processing."

Sec. 206.262 - Transportation allowances

Delete all of section 206.262.

Justification:

The use of a depletion based benchmark as the starting point for determining net royalty value eliminates the need for this allowance. Outbound transportation is specifically excluded from the definition of gross income from the property by IRC section 613(c)(2) which reads:

IRC [Sec. 613(c)]

> (c) Definition of Gross Income from Property--For purposes of this section--
>
> (2) MINING--The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

Sec. 206.262 - Transportation allowances cont'd

In the rare situation where outbound transportation was included in the selling price, it will have been removed in calculating gross income from the property for federal percentage depletion purposes. MMS need not be concerned about an excessive deduction because the coal producer will make every effort to legally maximize depletion by minimizing the outbound transportation adjustment. The natural self-policing effect of this approach would reduce the audit function in this area to a simple verification that gross royalty value equals gross income from the property for percentage depletion purposes.

Sec. 206.263 - Contract submission

Renumber to section 206.262 and change to read as follows:

(a) The lessee and other payors shall make available **[submit]** to MMS, **[upon request]** for review contracts for the sale of coal from ad valorem leases subject to this subpart.

Note: Delete everything following this sentence except for the last sentence, as follows: "Nothing in this subsection shall be construed to limit the authority of MMS to obtain or have access to information pursuant to 30 CFR Part 212."

(b) Lessees and other payors shall designate, for each contract **[submitted pursuant to this section]** whether the contract is arm's-length or non-arm's-length.

* * *

(d) Information **[required to be submitted]** made available under this section which constitutes trade secrets and commercial and financial information which is identified as privileged or confidential shall not be available for public inspection or made public or disclosed without the consent of the lessee or other payor, except as otherwise provided by law or regulation.

Sec. 206.263 - Contract submission cont'd.

Justification:

The proposed regulations now provide that the lessee will submit its contracts and related documents "upon request". While the regulation recognizes that commercial information, trade secrets and confidential information will be treated confidentially, there is no assurance that contracts and contract amendments will be included in this category of protected information. For example, we believe that not only the price, but the pricing provisions of the coal supply contract, represent valuable commercial information. Those companies that have witnessed disclosure of information they assumed would be treated as confidential in the government's files are understandably doubtful that the government will necessarily agree with this interpretation. Certainly the proposed regulations provide no basis for comfort in this regard. For these reasons we believe that our prior comments continue to be appropriate.

Both sections 206.253(d) and 206.259 require the submission not only of all coal supply agreements, but also any amendments or modifications to these agreements within 60 days of execution. While we do not dispute the legitimate right and authority of MMS to request a review and audit of such coal supply agreements and amendments, we would urge that lessees not be required to submit such contracts to MMS for their files. Coal supply agreements contain extrememly proprietary information, which, if divulged to the public and/or competitors, can have a

Sec. 206.263 - Contract submission cont'd.

significantly negative impact upon both the coal buyer and the coal seller. While we understand and respect all the intentions of MMS to keep such information confidential and proprietary, an amendment to the proposed regulations that would merely recognize the right to inspect, review and audit the coal supply agreements would be preferable because it would greatly reduce any unfortunate occurrences of such contracts being inadvertently released to improper parties. We think that the proposed requirement reflects not only a case of unnecessary overkill, but can have a significantly anti-competitive impact on the mining industry that is neither justified nor required in order to validate the value of the coal in calculating royalties.

Contract price is generally comprised of a (1) base price, (2) adjusted base price, and (3) other economic factors that directly affect the valuation of the coal. Specific cost factors that will adjust the base price consist of such items as wages, compensation factors, benefits, changes in federal/state laws or regulations, and numerous other items. While these items are listed in the contract, the specific methods for calculating such adjustments are typically made quarterly or at some definite time period and are subject to constant negotiations and customer audits. Factors affecting the price of the coal are, therefore, not static and as such cannot be specified in the terms of the contract.

Sec. 206.263 - Contract submission cont'd.

Since contracts are written in general terms, it is questionable what value they would be to MMS in computing royalties. The final price for the coal, on which the royalty is based, is determined through the process of properly accounting for the sale/purchase price. In addition, it is our understanding that MMS is developing its own financial audit team, through which all necessary contractual information could be obtained. We suggest MMS clarify its reasons for such an extensive requirement since we see no practical purpose to submit, for public record, all the information contained in customer contracts and related price adjustments.

In addition to the appropriateness of requesting this information, we have significant concerns regarding the assurance for confidentiality when releasing this information outside our offices. Bear in mind, it is the contract in conjunction with the method of administering this agreement that is highly proprietary and sensitive in nature and consequently is not subject to release as a normal business practice. The way a contract is administered determines how cost factors will be interpreted and adjusted over the life of that contract. While the factors being adjusted may be relatively standard from contract to contract, the process of administering such factors and, thus, establishing a "value" for the coal for each customer, is not a uniform process because of the nature of the marketplace.

Sec. 206.263 - Contract submission cont'd.

Customers will, for whatever reason, vary regarding what they are able and willing to accept in price adjustments. Consequently, it is inappropriate for a producer to establish, and unreasonable to expect a producer to establish, a set formula for adjusting cost factors among all customers. Rather, contract cost factors are administered using a very sophisticated and highly complex process of negotiation between producer and customer. Such a process is ongoing and constantly being tailored to the specific needs of each customer. Having access to general terms and conditions in the contracts without knowledge of the negotiating events transpiring to administer these factors will not enable the government to monitor a lessee's revenues from the sale of federal coal. Rather, as previously stated, "value" determinations can only be attained through detailed financial and accounting records on which royalties are currently paid.

Sections 206.253(e) and 206.263(d) regarding safegaurding the proprietary nature of the information contained in our contracts is of little solace. Numerous events can be cited that would cast serious doubt as to the ability of any government agency to keep information confidential. We question MMS's statutory authority for maintaining such confidentiality. Sections 4(b)(3) and 8A(d) of the Mineral Lands Leasing Act, as amended, require the Secretary to maintain confidentiality of all proprietary data or information obtained as relates to comprehensive Departmental exploration programs, but say nothing regarding

Sec. 206.263 - Contract submission cont'd.

royalty collection. Moreover, section 8A(d) specifically states that such confidentiality requirements end "after the areas involved have been released."

Furthermore, at a meeting on February 17, 1984, in Denver, regarding an early draft of these proposed rules, MMS officials mentioned that any agency, that "expressed a need" for such information, would have access to all information submitted to the MMS, and would be held under the same confidential restrictions required of MMS. We not only have significant concerns with MMS's authority under MLLA to maintain a necessary level of confidentiality, but seriously question the enforcement authority of MMS over other agencies.

While we recognize the Department's concern with having this information close at hand, given the complexity of an operator's records, we believe there are more efficient means for fulfilling the Department's obligations. The Department always retains the authority to audit the lessee's prices to assure that royalties are paid in proper amounts and at the proper time. We recommend that after a thorough internal audit, if the lessee's contracts are reasonable, and there is no need for further review, that the contracts be maintained on the premises of the lessee, with the understanding that the Department has the right to review the information at any time upon reasonable notice by the MMS.

Sec. 206.263 - Contract submission cont'd.

Finally, we wish to note that the Royalty Management Advisory Committee recommended that contracts be reviewed on site. We therefore urge MMS to rethink these provisions and to revise them in accordance with our suggestions.

Sec. 206.264 - In-situ and surface gasification and liquefaction operations

Delete in its entirety, renumber to section 206.263 and insert the following:

If an ad valorem federal coal lease is developed by in-situ technology, the value of production for purposes of computing royalty shall be determined by MMS. If coal from an ad valorem federal coal lease is produced using conventional mining methods and subsequently liquefied, gasified or thermally dried to remove inherent moisture, the royalty shall be based on the net royalty value of the feedstock coal determined pursuant to Section 206.259 at the point the feedstock first achieved marketability.

Justification:

The unlimited authority to value coal used for gasification or liquefaction is too broad and opened. The result will be a dampening effect on the development of new technologies. Accordingly, we suggest that the broad authority be restricted to in-situ processes only and that post mining processes such as liquefaction and thermal drying be excluded from royalty valuation by applying the provisions of Section 206.259 to the value of the feedstock coal when it first becomes marketable. The risks associated with capital expenditures and market development

Sec. 206.264 - In-situ and surface gasification and liquefaction operations cont'd.

for new coal products and technologies are not shared by the lessor. Therefore, the benefits, if any, accruing to such risk taking should not be shared by the lessor. The lessor should share in the benefit of such processes only to the extent of royalty at the prescribed rate on the value of feedstock coal at the point the feedstock coal first achieves marketable condition.

Sec. 206.264 - Disputed amounts

Add a new section 206.264 as follows:

Whenever a dispute as to the amount owed on a royalty arises by the government's demand for payment plus interest, the lessor and the lessee may enter into a contract whereby such disputed sums placed into an escrow account to be held by the United States Government with the interest accruing under said account to be available upon final resolution, either by administrative or judicial determination to be paid to the prevailing party. In the absence of such a contract for interest bearing escrow account, should the lessee prevail in the administrative or judicial resolution of a disputed amount of royalty due, the government shall allow a credit for the amount of over-payment, plus interest accrued, to be applied to the lessee's future royalty obligations.

Justification:

As more ad valorem leases are audited, it is likely that disputes will continue to arise as to royalty valuation determination issues. While the government has alleged that it has a common-law equitable right to interest on deficient royalty payments, it has disclaimed a similar right to lessees who have been determined, upon administrative or judicial appeal, to in fact have made an over-payment of royalties due. While it may be argued by the government that the United States cannot provide or pay interest on judgements without the express consent or approval of the Congress, it does not seem to preclude the government's recognition of such over-payment, along with the interest accrued, through means of an escrow account system with payment of the interest going to the prevailing party. Another suggestion is to allow credits on royalties due in the future, including the interest earned on the original over-payment of royalty.

Sec. 218.201 - Royalty payments

Change to read as follows:

Section 218.210 Royalty payments.

Operators/lessees shall submit royalty payments as provided for in the lease and the regulations in this Title. The payment shall be made by the end of the month after the end of the royalty reporting period for which the royalty accrued. However, if a different reporting period is provided for in the lease, the lease terms shall prevail.

Justification:

This provision as proposed will serve to automatically convert some lessees who are currently on a quarterly reporting basis pursuant to the terms of their lease to a monthly payment process. This could result in significant burdens and costs that in our view are unnecessary and unjustified. We therefore suggest the inclusion of language that will preserve existing lease terms regarding royalty payment periods.

Senator **Melcher**. Martin, would you just cite which parts of those proposed regulations would do that?

Mr. **White**. Senator, the level of royalty, the 12½ percent royalty, calculated in the manner that is shown in the MMS proposal compared to the Federal royalty we are paying on leases that were entered into prior to the passage of the Amendments Act of 1976—that difference equates to adding 80 to 100 feet of overburden to all of the coal that we mine in Rosebud County.

Senator **Melcher**. I understand that. That's the cumulative effect.

Mr. **White**. That's an accumulative effect on every single ton.

Senator **Melcher**. Now, what you've been doing is operating under a type of computation of what the royalties are for how many years? Fifteen years or so?

Mr. **White**. Twenty years.

Senator **Melcher**. Twenty years, ever since Colstrip got going again.

Mr. **White**. Yes.

Senator **Melcher**. And it is true that on transportation many of your contracts are such that the transportation cost is much higher than the cost of the coal, is it not?

Mr. **White**. That's correct.

Senator **Melcher**. I understand these regulations would say that 50 percent of the transportation costs would be allowed except when the Secretary determined otherwise. Isn't that true?

Mr. **White**. Well, the regulations, as I understand them, have the potential to allow transportation costs to be included. They allow for the discretion of the transportation cost to be included in the calculation of the royalty.

Senator **Melcher**. But up to 50 percent of the value of the coal.

Mr. **White**. Yes, that's correct.

Senator **Melcher**. Just give me a for instance what that coal is valued at as it is loaded on a car in your operation at Colstrip.

Mr. **White**. Well, since some of my competitors are sitting here in the room, Senator, I'll give you kind of a rough number.

Senator **Melcher**. Give me a gross number. Just give me a gross number.

Mr. **White**. Say, around $10 a ton.

Senator **Melcher**. And some of that transportation cost is what?

Mr. **White**. Well, it would depend on where it's going but, say, $13 a ton.

Senator **Melcher**. Thirteen. So, that would be $6 dollars and a half then.

Mr. **White**. Yes.

Senator **Melcher**. Unless the Secretary determined otherwise.

Mr. **White**. That's correct.

Senator **Melcher**. What's an arm's length contract? What does that mean?

Mr. **White**. Pardon me?

Senator **Melcher**. What does an arm's length contract mean?

Mr. **White**. Well, an arm's length contract is the kind that we have where you sit across the table and hammer out an agreement between two parties and arrive at some method of compensating one another for the product we sell in our delivering the product.

Senator **MELCHER**. That is between you and whoever is going to burn the coal.

Mr. **WHITE**. That's correct.

Senator **MELCHER**. And the arm's length contract you have with the railroad—how is that arrived at?

Mr. **WHITE**. Well, right now we don't have the contract with the railroad. But our customers——

Senator **MELCHER**. There isn't any such thing, is there? Isn't it just a rate they established?

Mr. **WHITE**. Well, it has historically been that. But there are contracts now between our customers and the railroad.

Senator **MELCHER**. Between the customer——

Mr. **WHITE**. That's correct, yes.

Senator **MELCHER**. Do you agree with this MMS proposed definition of an arm's length contract?

Mr. **WHITE**. No.

Senator **MELCHER**. Do you want to tell us more about that?

Mr. **WHITE**. I'm going to let Don explain why we disagree.

Mr. **COOVERT**. Senator, the problem we have with that definition which essentially says that if one party owns any interest in the other party, the contract is not arm's length, is that that would render probably the vast majority of contracts as not arm's length. Our view is that when an arm's length contract is not arm's length is when one party has enough of an interest to impact the price.

Senator **MELCHER**. Give us an example.

Mr. **COOVERT**. Well, a good example would be, let's say, my company is working with a utility, and we through our pension plan have some shares of stock in that utility, which is fairly common. We would not technically be arm's length under the MMS proposed definition; whereas, the way we look at this, the Internal Revenue Service and BLM and various other agencies use definitions of arm's length that are much more realistic and get to the point of control. If there is no control between the two parties, then it follows that their price negotiations would be arm's length.

Senator **MELCHER**. Well, first of all, I got a copy of these regulations as they were published in the Federal Register last January 15, and it says, "or if one person owns an interest," and then "(regardless of how small) either directly or indirectly in another person." Then the benchmark, as I understand it, would be established. That just triggers a benchmark.

Mr. **COOVERT**. Right.

Senator **MELCHER**. So, under the situation you're describing, if one of your officers of Amax owned some stock in a utility with which you had a contract, no matter how small, that would automatically trigger these benchmarks. Is that right?

Mr. **COOVERT**. I'm not so sure the officers' ownership would, but the company's ownership would.

Senator **MELCHER**. The company's ownership.

Mr. **COOVERT**. Even one share, no matter how small.

Senator **MELCHER**. If the company owned one share.

Mr. **COOVERT**. Right.

Senator **MELCHER**. Then that is frequently the case, is it? Are you telling me that?

Mr. COOVERT. No, not the company directly, but the company's pension plan may well own, for instance, shares.

Senator MELCHER. Oh, the company's pension plan.

Mr. COOVERT. That's right. That's right.

Senator MELCHER. Oh. And that involves you then.

Mr. COOVERT. Yes.

Senator MELCHER. And there are other definitions by BLM?

Mr. COOVERT. The BLM definition——

Senator MELCHER. It used to be the Bureau of Land Management was part of the Department of the Interior under the Secretary of the Interior just like MMS is. I guess it's still that way this morning yet, isn't it?

Mr. COOVERT. I believe it is, yes.

Senator MELCHER. Well, we'll have Steve Griles who will assure us one way or the other.

So, BLM has a definition of arm's length contract, which has been in effect a while?

Mr. COOVERT. Yes. The BLM definition essentially says from 0 to 20 percent ownership, there's a presumption of arm's length, and from 20 to 50 I believe it is, there is a rebuttable presumption. From 50 up, there's control.

Senator MELCHER. I see.

And then about these benchmarks, as I have got them here, the benchmarks are gross proceeds from a non-arm's-length contract, et cetera; secondly, the gross proceeds on a non-arm's length contract measured against arm's length contracts between other parties in the area; third, the coal prices reported for the coal being valued to a public utility commission; and fourth, the coal prices reported to the Energy Information Administration; five, other relevant matters.

What are other relevant matters? Is that as broad as those three words seem to indicate?

Mr. COOVERT. I would presume that what that is is an attempt to leave the door open in case A, B, C, and D don't produce desirable results.

Senator MELCHER. And then, six, a net back calculation.

Listen, has anybody got another plan to take care of these proposed regulations?

Mr. WHITE. Yes, we do. We have a proposal——

Senator MELCHER. Good. Can you describe——

Mr. WHITE [continuing]. That we would like to submit to you. It's a joint industry proposal that I think virtually anybody involved in the calculation of these royalties has agreed works better and is much simpler to administer.

Senator MELCHER. When you say anybody connected with royalties, I assume you mean States and Indian tribes? Is that right?

Mr. WHITE. I wish I could say that were true, Senator, but I guess I overspoke myself just a little bit. The producers and the consumers I think are the people that are in wholehearted support of this.

Senator MELCHER. And you're going to tell us, Martin, what this plan is.

Mr. White. Well, I'm going to let Don tell you what the plan is because he is the chief architect of the plan, and I think he deserves the opportunity to explain it to you.

Mr. Coovert. Well, in brief summary—and we've given I believe to the committee the detail of the proposal. But in brief summary, we have patterned a proposal after a system that has been in place in the State of Kentucky for a number of years relative to their ad valorem severance tax. It uses as a starting point for the valuation process depletable income for Federal income tax purposes rather than the separate contract-by-contract construction of so-called gross proceeds. It uses that starting point because it already exists, because it is audited by other Federal and State agencies, and because a number of disputes over the years have been laid to rest by litigation and, therefore, it is relatively tightly defined.

Going beyond that, however, we have proposed certain adjustments to value to arrive at what we term net royalty value after the removal of the royalty itself and the State and local taxes based on production, as well as the Federal taxes based on production.

The other significant aspect of this proposal is that it is tied to a fixed point in the valuation process as opposed to a floating point in the process. We proposed that coal be valued immediately upon achieving marketable condition without regard to what happens thereafter.

The one other thing that I would say about our proposal is that we know how expensive it is to administer a program like this under the gross proceeds concept as compared to a depletion based program simply because we have experienced with the State of Kentucky on depletion based valuation on the one hand, and we have experienced with gross proceeds auditing on the other hand because our customers, of necessity, use that methodology when they come in to audit their price for their contract. And we know that in general terms—and I won't go into the details because it is in what you've already been given—that the cost of gross proceeds of valuation on a contract specific basis, the cost of administration is greater than depletion based valuation by a factor of 10 roughly speaking.

Senator Conrad. And what is the reason for that?

Mr. Coovert. The reason is because—I'll use one of our mines as an example. We have at one of our Western Federal lease mines seven contracts presently in force. Using contract specific gross proceeds, the price will have to be constructed and verified for each of those seven contracts for that mine. Using depletion based valuation, the calculation is a mine calculation done one time for the whole mine. And it is also——

Senator Conrad. Done one time in its history? One time a year?

Mr. Coovert. One time each year. In both cases, each year. So, we are talking in that particular mine seven calculations versus one. And the one calculation takes less time than any one of those seven.

Senator Conrad. Okay. Let me ask this. There is an analysis that has been done by MMS that concludes that adoption of the proposal that you have made would result in a decline in revenue on an annual basis of $80 million. They assert that their proposal would result in a decline in revenue of $13 million.

We would be interested in your reaction as to whether or not MMS' analysis is correct, and if you don't agree with it, why not?

Mr. COOVERT. Our reaction is that the MMS number is excessive. And we have provided to you an analysis that gets into the detail of where and why we think it is, and also provides what we think is a realistic set of numbers as to the impact of the industry proposal.

Senator CONRAD. For the purposes of the record, perhaps you could give us your alternative analysis in terms of the bottom line, and then perhaps just the highlights on the differences.

Mr. COOVERT. Okay. Essentially the $80 million number you referred to is in the narrative of the MMS analysis. When you get into the detailed schedules, it appears to us that they are saying it is really $67 million instead of $80 million. And when you get into their schedules, you find, for instance, the largest single factor causing a major distortion is that the industry proposed deducting Federal royalties for purposes of calculating the Federal royalty to prevent compounding.

And you will notice in the detail that we have provided that often the MMS calculations would deduct royalty of three or four times as much as would actually occur. And since that's a very large number, that severely distorts the results. In fact, our analysis strongly suggests that the impact is not $80 million or $67 million, but something like $38 million.

And I would also add one further comment to that. When we are talking about these impact numbers, we should always keep in mind that total revenue from Federal coal royalties is going up, not down, no matter what alternative is adopted because we are going through this transition from cents per ton to ad valorem at the same time.

Senator CONRAD. All right. Thank you for making that point.

Do you have any thoughts on why they would have come up with a royalty deduction that was three of four times what would actually be the case? If that is the source of the distortion or the greatest part of the distortion, why would they have come up with an estimate for royalties that were three to four times what would actually pertain?

Mr. COOVERT. I would make two comments relative to that. First of all, I think I would like to let the Department speak for themselves as to what their calculations mean. I would make one observation, and I think it is valid, and that is their analysis kind of suggests that maybe they didn't exactly understand our proposal.

Senator CONRAD. All right. That sometimes happens.

Mr. COOVERT. Yes.

Senator CONRAD. Let me ask you this.

Mr. WHITE. Excuse me. Could I make another point relative to that?

Senator CONRAD. Certainly.

Mr. WHITE. I think one of the other challenges that has to be addressed as we look at the revenues from the royalty is what the marketability of Federal coal will be under that new royalty rate. And at our mine—and I'm aware that it is occurring at other mines—we are doing everything we can to avoid Federal coal because that increase in the royalty takes the coal out of the marketplace. We cannot sell that coal. And therefore, we are mining around that coal. We have a team of engineers that does nothing but try and plan how we can effectively mine around Federal coal.

And therefore, the Federal Government is pricing its product out of the marketplace. And I think their price is about three times what the average for the rest of the industry is.

So, whenever they make a projection of what future royalties will be, if their assumption is that they can raise the royalty and experience the same production level, I think that is a very questionable assumption.

Senator CONRAD. Let me pursue that. On the coal we were just talking about that had transportation cost that might average $13 a ton and had a cost of $10 to the underlying value of the coal, how much would be paid in Federal royalty typically? We had $10 coal.

Mr. WHITE. Well, historically the rate has been somewhere around 17½ cents per ton. And the number I'll give you now is a rough number, but it would change it to about a buck and a quarter a ton or—yes, a buck and a quarter a ton—if you had a 12½ percent royalty. And that's how I arrived at the statement I made earlier about adding 80 to 100 feet of overburden that would have to be moved, or it was comparable to doing that.

Senator CONRAD. Because that is the equivalent cost to you of dealing with an overburden.

Mr. WHITE. That's exactly correct.

Senator CONRAD. Let me ask one other question that relates to the base value. Your proposal would base value on the concept of gross income from the property determined in accordance with the Internal Revenue Code provisions relating to coal depletion. This base does not include take or pay payments. Why do you believe they should not be included in the value of coal?

Mr. WHITE. The resource that the government owns is still in the ground and still has to be produced. The coal has not been taken from the ground and prepared for sale if there's a take or pay payment made. Therefore, the government should not participate in this penalty payment.

Senator CONRAD. All right. I also understand that you don't believe State severance taxes or Federal black lung tax or Federal AML payments should be included in the value of the coal. For the record, can you give us your rationale for that position?

Mr. WHITE. Yes. The royalty is supposed to be based on the production value of the coal. And the adding of a severance tax or a black lung tax or any other tax or royalty does not increase the value of coal. It may even decrease the value because it has increased the price so much. So, we do not feel that those are value-added parts and, therefore, they should not be included in the calculation of the value of coal.

Senator CONRAD. Could you just briefly tell us how the MMS proposal rules differ from the existing practice?

Mr. COOVERT. I'll attempt to. I think this is a disputed issue, first of all.

Senator CONRAD. We understand that.

Mr. **Coovert**. From our perspective we find less than total authority in the existing regulations for including proceeds from any coal or from any other source other than produced coal, which would include this so-called take or pay issue or any other issue related to whether we as a coal producer charge the highest possible price to the coal consumer.

It is our view that the current regulations would levy a royalty on the arm's length selling price of produced coal FOB mined. The MMS position appears to be that the new proposal is a recodification or a codification of their exiting practices, but we think it goes beyond that. We think adding the highest and best price and take or pay and compounding the royalty and so forth are additions rather than just codification.

Senator **Conrad**. Let me turn your attention to a matter that involves a more parochial interest. In my State we have low Btu coal, lignite coal. We operate in mine mouth operations, long-term, fixed cost, cost plus contracts. What would be the effect of the MMS proposal as you see it on a State like mine that operates under contracts that are long-term-cost plus?

Mr. **White**. It's my theory—and I think it is fairly well-held—that in a situation where we have surplus generating capacity and people are out there trying to market their electricity, it doesn't make a difference whether you have a mine mouth contract that is, as you stated, cost plus. If the price of that fuel drives the cost of electricity up so it will not compete in the marketplace, that fuel is not going to be supplied. And so, the perception that you have a cost plus contract and you have a mine mouth situation protects you from all of these added costs is not correct. That electricity competes in the marketplace. And it's a very, very difficult marketplace right now. There are utilities that have 80 percent surplus capacity. So, that electricity has to compete. And one of the main incremental costs is the fuel that goes to the plant. So, I don't feel that provides any protection.

Senator **Conrad**. What about the proposal that you are making? What would be the effect of a State that had mine mouth operations?

Mr. **White**. The proposal that we are making obviously has an effect of keeping the price of the fuel at a lower level. Therefore, there is a potential for more of the fuel to be supplied to the power plant because the cost is lower, and more electricity would be sold. But because more coal is produced, it may be that, even though the formula we provide or we are suggesting would result in a lower royalty add-on to the value, it would increase the revenues to the government because there would be more coal produced.

Senator **Conrad**. More Federal coal produced.

Mr. **White**. More Federal coal produced. That's correct.

Senator **Conrad**. How much of a difference are we really talking about here? If we're talking about the $10 coal that we were using in the previous example, how much of a difference on a per ton basis are we talking about between their proposal and your proposal? Have you made a calculation like that?

Mr. **Coovert**. In rough we have, yes. You are talking about the $34 million that we referenced earlier.

Senator **Conrad**. Right. I think we should use your assumption.

Mr. COOVERT. Translated into tonnages or percentages, the difference there is probably—an educated guess is in the 20 percent range.

Senator CONRAD. A 20 percent difference per ton.

Mr. COOVERT. Yes. And it will vary depending upon things like you just mentioned, a mine mouth operation. The percentage difference will be less.

Senator CONRAD. And how much less in a mine mouth operation?

Mr. COOVERT. Probably about 4 or 5 percent less. So, you're talking maybe 15, 16 percent on a mine mouth compared to a 20 percent average.

Senator CONRAD. I assume you have discussed these proposals with MMS and their officials.

Mr. COOVERT. Yes, we have.

Senator CONRAD. That's a correct assumption.

What do they say to you when you make the points that you have made here?

Mr. COOVERT. Well, essentially I think the point is made from their perspective that they are trying to treat us the same as other fossil fuels. Our reaction to that is that, first of all, we are not the same and, secondly, when you apply the same mechanical provisions to arrive at royalty, you don't get the same results because we don't sell our coal like they sell gas and oil.

Senator CONRAD. And really, isn't that the nub of the issue? Aren't we right on point here? Their view is that if you have the same approach mechanically, that you get the same result. And your answer is, well, superficially that might appear to be the case, but in reality we have an apples and oranges situation.

Mr. COOVERT. That's precisely the point.

Senator CONRAD. And what is the central difference between the fuels that leads us to a result that is different even though you use the same mechanical approach?

Mr. WHITE. I might address that. The difference between the two products, oil and gas, as compared to coal is how they are developed and how they are produced. And I think most of us in the room have probably been to a coal mine and seen the number of men and machines it takes to produce a ton of coal and the disturbance of the earth. I was to one of our Wyoming gas wells recently, and we have a well sitting out there which somebody drives by in a pickup once in a while and checks on it. But it is pumping that gas out of the ground every day and moving it through a pipeline. That is not the case in a coal mine. There are a large number of people working with heavy equipment disturbing many acres every single day. And to compare a royalty in one instance to a royalty in the other is ignoring that the two products are different.

And they are sold into the marketplace different. Oil, as you know, is sold as a commodity, and the price really isn't site specific. Coal is sold to specific customers under specific contracts.

Senator CONRAD. I think that is the central difference.

Mr. WHITE. I think it's a very central difference, yes.

Senator CONRAD. Mr. Peterson, we would very much like to hear from you and have a chance to hear your statement.

STATEMENT OF DAVID H. PETERSON, DIRECTOR OF FUEL SUPPLY, NORTHERN STATES POWER CO., ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

Mr. PETERSON. Thank you, Senator. I very much appreciate the opportunity to be here this morning. And in addition to NSP, I'm also representing the Edison Electric Institute.

There are six brief points I would like to go over with you this morning. I'll give you a little background on NSP, how we view the overview on Federal royalties, give you a brief characterization of how we saw the coal market in 1976 when the FCLAA act was passed and what that market looks like today, why we think the DOI valuation process is unfair, what happened to NSP's coals from 1983 to 1987, and finally what we would like this committee to do.

First off, NSP is the largest utility in the upper Midwest. We have got a million customers. We burn about 9 million tons of coal a year of which approximately 6 million comes off from Federal leases or has the potential to do so. And of course, I think you are familiar with who EEI is.

In our opinion Federal coal royalties do set the market in the West for coal royalties whether it be private or Federal. And with Federal royalties going to an ad valorem basis, it is just a matter of time until all royalties in the West go to an ad valorem basis. That it is very similar. The Federal Government owns two-thirds of the coal in the West.

The intention, back in the 1970's when the act was passed, was a fair return to the public with the Department of the Interior being allowed to determine what the value of the coal would be. And of course, that's the current debate.

Back in the mid-1970's I think you could represent the coal industry and as related to the power industry as a period of rapid expansion. Coal prices for utilities were secondary to the availability of fuels. Some of us had just gotten cut off from gas. Oil was a major problem, and we were in a very rapid expansion program. And so, our main concern was capital dollars for power plant construction. Coal prices in the West at the time were relatively low, and I think it was presumed all along that the Department of the Interior would be reasonable on how they determined coal values.

And 1987, on the other hand, is totally different. In our business there is slow or no growth. The marketplace for coal is being threatened from many different places. There is plentiful gas again in many parts of the country. And of course, there now is more hydroelectricity available, and in our case particularly from Canada.

Coal prices went way up. They have gone way down. But they have never gone back down to the levels they were in the 1970s. The reason for that is primarily regulations, taxes and some inflation.

The valuations by the Department of the Interior, as we see them, and some of the problems with that are that as a consumer, we are going to be paying taxes on taxes and royalties on royalties. Everything is included, all State and local taxes and everything else, which we think has very little to do with the value of the coal.

The value could include clean coal technology capital if it is done at the coal mine. Again, it has nothing to do with the value of the coal in the ground.

Coal liquefaction, gasification or drying can also be included in the royalty value, again having nothing to do with the value of the coal in the ground. It needs to be upgraded to be more environmentally acceptable, for instance.

Take or pay payments—and I might embellish a bit here. Take or pay payments are generally made to a coal mine for a number of reasons, but it is primarily to cover the capital cost for building the coal mine originally. And the reason utilities do not want the coal is either it is too expensive or they just plain do not need any coal. It has, again, nothing to do with the value of the coal in the ground or as it is being extracted.

The Department of the Interior has a very large potential to determine arm's length prices because of the definition in the regulations. And probably one of the most troublesome parts, at least for me, is they could become a third party to almost all coal price meetings we have with any of our coal suppliers. And I have a real problem with that. I have enough trouble dealing with the coal vendors without having the Department of the Interior in there on their side.

The proposed regulations for sure will increase the cost of coal for all western coal users and we think beyond any reasonable measure. If the regulations are adopted, the forms of energy that would be used to produce electricity will probably be non-Federal coal, at least more than it is today.

This gets me to the fifth point I had of talking about NSP, and the reason I want to do that is Martin mentioned earlier that they have produced roughly 150 million tons since the late 1960's. NSP has taken between 50 million and 60 million tons of that coal. We have been one of their largest users for many, many years until very recently.

In 1983-84, NSP took roughly 7 million tons out of Montana. And that level of consumption had been roughly in that area for about 7 or 8 years. By 1986-87, that same number out of Montana was 3½ million tons.

And why did we do this? The coal basically was not competitive. Several reasons. One was severance taxes in Montana. And there has been something done about that recently. Part of it is Federal coal royalties that the coal was marginally competitive, and with application of percentage royalties, it became noncompetitive.

Where did the energy come from? And Senator, you I'm sure would like this. Non-Federal coal in North Dakota, lignite. Some of it came from——

Senator CONRAD. I like that, yes.

Mr. PETERSON. I would expect you would, sir. [Laughter.]

Some of it from Manitoba Hydro, a little bit of coal from Wyoming, and Indiana low sulfur coal, again not subject to Federal royalties.

Other utilities were noticing or using more gas, non-Federal coal, and in some cases taking in foreign coal because it is now competitive where it wasn't previously.

We would like to suggest that you prevail on the Department of the Interior to accept the industry's position. Thank you.

[The prepared statements of Mr. Peterson and Mr. Krumins follow:]

TESTIMONY ON

COAL PRODUCT VALUATION REGULATIONS

BEFORE THE

SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT & PRODUCTION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

by
David H. Peterson
Director, Fuel Supply

Northern States Power Company
on behalf of the
Edison Electric Institute

November 16, 1987

Good Morning, Mr. Chairman. I am David H. Peterson, Director of Fuel Supply at Northern States Power Company (NSP). It is my pleasure to appear this morning on behalf of my company as well as the Edison Electric Institute (EEI) to discuss coal product valuation regulations.

The Edison Electric Institute is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. They generate approximately 76 percent of all the electricity in the country and serve 73 percent of all ultimate customers in the nation.

NSP is the largest electric utility in Minnesota and also serves portions of four other states: Michigan, North Dakota, South Dakota, and Wisconsin. We have approximately 1,000,000 customers. Each year we burn between eight and nine million tons of coal. About six million tons of that coal is produced by mines that have federal leases. The balance of our coal comes from Indian or private leases. Federal government actions can and do set the market for non-federal Western coal royalties since the federal government is such a major lessor in the West.

The North American Electric Reliability Council (NERC) reported that in 1985 electric utilities nationwide used approximately 218 million tons of Western coal. Because of the way in which coal produced on federal leases sets the market for all western coal, it is likely that costs will increase on all Western coal because of changed royalty calculations. Because federal royalties are now in the process of changing from a fixed to an ad valorem basis, we appreciate this timely opportunity to testify on a matter that has a significant cost bearing to every customer of any utility using coal from Western sources.

Different product value regulations for each of the fossil fuels are necessary. This is because the utility use of oil, gas and coal are different and their business characteristics vary (i.e., oil and gas pricing are based on market pricing whereas coal contract pricing is based on production costs. The capital costs of oil and gas development are relatively small compared to coal and these fuels are often used for different purposes such as peak demand, therefore, there should be different product valuation regulations for the various fossil fuels.

Pricing of fossil fuels is crucial to our industry. Fractions of cents in fuel prices do make the difference between the bids that we accept or reject. It is important for federal policy makers to pay careful attention to the role that their decisions will have on a market particularly a cost-driven market such as coal.

In a study commissioned by The National Coal Council, Improving International Competitiveness of U.S. Coal and Coal Technologies, it was reported that, "As royalties on federal leases move from a fixed rate per ton to a percentage of value (i.e., 12-1/2 and 8 percent for surface and underground mined coal, respectively), those reserves become less competitive in international markets. This naturally favors less expensive privately-owned coal or state and/or private leases over federally leased coal. The Federal Government should review the appropriateness of these high percentage-based royalty rates."

Increasing the cost of coal by significantly increasing federal coal royalties makes federal coal less attractive and competitive for utility buyers. Switching can and will occur to other non-federal leases, leases not yet subject to new federal royalties, or to other fuel types, including imported coal and electricity, oil, or gas. For example, Southwestern Public Service Company, which serves parts of Kansas, New Mexico, Oklahoma, and Texas, is purchasing coal, where possible, from a non-federal mine not subject to increased royalties. Those utilities which are able to utilize different types of coal and alternate fuels will examine the economics to determine which is the cheapest fuel to use.

In New Mexico, coal producing property in the Raton Basin has been for sale. The coal property is not on federal land and is instead owned by the mining company marketing it. In spite of the very soft market for coal (in which some spot prices in Wyoming are about $3.25/ton), the market to purchase this mine was very competitive. This may be an indication of the desirability of coal that is not subject to the increased costs associated with federal royalties.

BACKGROUND

On August 4, 1976, Congress enacted the Federal Coal Leasing Amendments Act (FCLAA). The Act intended to provide a fair return to the public for the use of the public's coal. The basic provision of the law changed the federal royalty rate from about $.20/ton (depending upon the lease) to 12.5 percent of the "value" for surface-mined coal and 8 percent for underground coal. "Value" was to be defined by The Department of Interior (DOI) and it is this definition that is now being debated.

DOI interprets the FCLAA as automatically requiring the application of FCLAA royalty standards to all leases signed before and after 1976, as those leases come up for renewal. The terms of most of the original leases were 20 years with ten year renewal options. Most western coal purchased by utilities is produced on leases currently up for renewal or which will be readjusted prior to 1995.

The ADVERSE IMPACTS OF THE MMS PROPOSED RULE

On January 15, 1987, The Minerals Management Service (MMS) of The Department of Interior (DOI) proposed revised coal product valuation rules. Prior to that, DOI had utilized a panel to advise it on how to develop product valuation regulations for coal, oil, and natural gas. This panel, known as the Royalty Management Advisory Committee (RMAC), did not include a participant from the electric utility industry. There was therefore no early opportunity for utilities to present the views of consumers to MMS as they prepared to draft product valuation regulations.

Both the coal and electric utility industries commented that the MMS proposed January notice of rulemaking is not beneficial to consumers or the economy in that the proposed rule contains the following major deficiencies:

- It is double taxation because it would incorporate state and local tax payments in the federal royalty calculations. DOI proposes to set the federal coal value at the coal sales price. However, the sales price includes all state and local taxes --- thus requiring royalty payers to pay a tax on a tax.

- It levies royalties upon clean coal technology development by assessing royalties upon the capital investments that industry and utilities undertake to make coal a more environmentally acceptable fuel. New coal technologies and processes, such as liquefaction, gasification and thermal drying are subject to the royalty calculation under the MMS proposal.
- A utility would have to pay royalties twice in some instances. For example, if NSP were to make penalty payments to a coal company under a long term contract because we were not taking the coal at that time, the proposal would require a royalty on those payments. Then, at a later time, when we took the coal, another royalty payment would be required.
- It would allow MMS to administratively set the price for coal if it did not feel that there was an arms-length contract between two parties. In fact, the way in which the definitions are drawn is such that if a utility pension fund owned one share of stock in a coal company, the coal procurement function would be deemed as non arms-length, and the price subject to determination by the MMS. This is an unwarranted expansion of MMS power that could place MMS at meetings between vendors and purchasers.

We believe that the MMS is inflating the value of coal for royalty purposes. Many items are being included in the value of coal to increase the royalties. Certain non-production payments will be included in the "value" of coal. Take-or-pay payments are an example of a non-production payment proposed to be in the royalty base. Take-or-pay clauses normally require the purchaser to pay for a minimum contracted volume. Under such a clause, the purchaser may have the right to take coal paid for (but undelivered) in succeeding years. These contracts, many with 20 or more year terms, required strict take-or-pay requirements in order for the coal companies to secure financing for mine openings. The proposed MMS definition may penalize utilities twice for this coal as royalty payments would be required with the take-or-pay requirement and again when the coal is actually purchased.

Regulations on product valuation are very complex and leave much discretion to DOI. In fact, the proposed regulations triple the length of current regulations. Because of the requirements of most coal contracts, the additional costs from the rulemaking will be reflected in the cost of the coal purchased by utilities and passed through to consumers. Therefore, EEI and NSP were participants in efforts to develop an alternative proposal which was agreed to by the coal industry as well as all segments of the power industry: public, private, and rural electric cooperatives.

The joint-industry proposal utilizes existing Internal Revenue Service (IRS) methodology for mineral depletion. This is a calculation which can be easily and economically audited by DOI without adding a large auditing staff to be certain they are receiving proper royalty payments. DOI again reopened the comment period in August, 1987 specifically seeking comments on the joint industry proposal. The comment period closed on October 13 and EEI and others filed comments supporting and clarifying the joint industry proposal. Attached is an executive summary of the joint industry proposal and a copy of our October 13, 1987 filing with MMS.

Due to the MMS's proposed pyramiding (double taxation) the effective royalty rate may be 14.3% or more. This is projected to bring the royalty to as high as $4.00/ton in certain cases with most royalties being in the range of $.55 to $2.50 per ton. The increase is expected to have a profound impact on the electric utility industry because the increased fuel cost, will ultimately be passed on to customers as part of their monthly electricity bills. The joint-industry proposal would moderate this increase by about one-third.

For example, assume we are utilizing Montana coal with a value of $10.00/ton. Under the fixed rate, our royalty would be from $0.20 to $0.225 per ton. Under the MMS ad valorem rate, our royalty would increase by at least $1.25/ton For the customers of NSP, this would mean additional fuel costs of $7-9 million annually.

Earlier this year the Western Coal Traffic League also estimated the costs of the MMS proposal to some of their members. They found the following increases:

Utility	Projected Annual Increase In Royalty Charges
Central Power & Light Company (Corpus Christi, Texas)	$4,800,000
Kansas City Power & Light Company (Kansas City, Missouri)	$2,100,000
TUCO, Inc. (Amarillo, Texas - provides coal to Southwestern Public Service)	$8,500,000
City of Colorado Springs (Colorado Springs, Colorado)	$2,500,000
Central Louisiana Electric Company (Pineville, Louisiana)	$2,700,000

In the FCLAA legislative history, the Council of Economic Priorities reported that the federal government collected $23 million in royalty payments during the first 54 years after the enactment of the Mineral Lands Leasing Act of 1920. This was on total production of 189 million tons of coal. More royalties are now collected in one year than were collected during that entire time frame.

In the Southwest, Mountain, and Pacific states, western producers will continue to provide 100 percent of the coal consumed in the region. In the Midwest, a substantial portion of the current coal requirement is from western coal mines. But in the face of nuclear capacity additions, hydroelectricity imports and low-cost natural gas and fuel oil, royalty-induced price increases for western coal will probably lead to losses in its share of the electricity generation market in some parts of the region.

The Energy Security Study of the Department of Energy, March, 1987, recognized royalty problems, when it said, "...Federal royalties on leases granted since 1976 generally have been 8 percent for underground mines and 12.5 percent for surface mines. When first imposed in 1976, these rates were far above prevailing levels; and if royalties on federal coal are excessive, the government may lose revenues in the long run -- while at the same time consumers pay higher-than-efficient prices for coal. In addition, pre-1976 lease royalties are typically paid on a cents-per-ton basis rather than being computed as a percentage. This situation may distort production away from the lowest cost coal supplies."

We urge DOI to again promulgate a draft or final rule which reflects the competitive concerns of consumers and does not raise electricity costs unnecessarily. The joint-industry proposal allows the government to determine value and collect royalties through a process that is already well established and allows IRS to audit annually.

CONCLUSION

The Federal Government and coal producing states are going to receive increased coal royalties as leases are renewed. The increases in these costs to electric utility customers will be substantial. The application of the coal product valuation regulation, as envisioned by MMS, ignore the economic realities of the energy market to the detriment of electricity consumers.

Unreasonably high royalties are certain to reduce coal competitiveness, resulting in increased dependence on other energy sources, including imported oil. The further loss of coal competitiveness could translate into higher unemployment and ZERO payments on coal left unextracted because of lost market.

The joint industry proposal is a methodology that will make it possible for the MMS to collect the increased royalties that are due it under FCLAA while moderating the possible increases to electricity consumers by about one-third. The alternative proposal is far superior to the MMS proposal both in terms of efficiency and administration. We find it to be in the beneficial interest of our customers, the states, Indian tribes, coal producers and the federal government and urge you and your colleagues to assist us in encouraging its adoption.

July 21, 1987

Mr. Dennis C. Whitcomb, Chief
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Building 85, Denver Federal Center
Post Office Box 25165, MS 651
Denver, Colorado 80225

RE: REVISION OF COAL PRODUCT VALUATION REGULATIONS
RELATED TOPICS, 43 CFR Part 3480

Dear Mr. Whitcomb:

On behalf of the industries that have been developing an alternative approach to coal product valuation, it is our pleasure to submit the attached alternative proposal to the Minerals Management Service (MMS) for consideration.

The industry alternative is based on rules proposed by MMS on January 15, 1987, at 52 FR 1840 and represents a significant revision of that proposal. Deletions are indicated with brackets and additions are underscored. Detailed justifications accompany each revision. We have attached an executive summary and a comparison chart of various points in the valuation process.

We believe that the approach embodied herein, utilizing the Internal Revenue Service Code for depletion calculations, results in a reasonable and time-tested alternative to the "gross proceeds" methodology advanced by MMS in January of this year.

Our preliminary calculations indicate that this methodology is fair to consumers and should not result in the artificial market impacts that are likely under the MMS proposal. It merits a careful review.

Sincerely yours,

William McCollam, Jr.

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LAWRENCE S. HOBART
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Richard L. Lawson

RICHARD L. LAWSON
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Fred Palmer

FREDERICK D. PALMER
General Manager
Western Fuels
Association, Inc.

EXECUTIVE SUMMARY

COAL/ELECTRIC UTILITY ROYALTY VALUATION PROPOSAL

Executive Summary

Valuation Concept

Coal valuation, for federal royalty purposes, should be based upon the following concepts:

- Value for royalty purposes should be determined at a fixed, defined point in the production process immediately upon completion of crushing and sizing of coal actually mined from federal leases (Point 6 on attached chart).
- Value should be calculated starting with an established and consistent benchmark which is "gross income from the property" as determined in accordance with the provisions of Internal Revenue Code Section 613 and related regulations (Point 8 on attached chart). "Gross income from the property" includes all income generated by mining, basic processing and loading functions. Each mine operated by a coal producer is required by Internal Revenue Service to calculate "gross income from the property" on a mine specific basis to claim statutory depletion.
- Value should exclude all processes and handling beyond the defined point of valuation.
- Value should exclude all direct government levies such as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees, state severance and production taxes.
- To arrive at net royalty value, it would be necessary to make certain mechanical adjustments to the IRC 613 depletion base. Specifically, it would be necessary to add all non-federal royalties attributable to coal produced from federal leases, since these amounts are the only portion of the selling price excluded from the depletion base. It would also be necessary to deduct the processing allowance as well as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees and state severance taxes.

The formula for determining net royalty value in accordance with this proposal may be expressed as follows:

$$\text{Net Royalty Value} = \text{Depletable Income From the Lease} + \text{Non-Federal Royalties Attributable to the Lease} - \text{Processing Deduction} \;\&\; \text{Direct Government Levies}$$

Impact On Specific Issues

Royalty valuation at a fixed point in the production process using the IRC 613 federal depletion benchmark will produce the following results:

1. Greatly reduce and simplify MMS administrative procedures and costs because the starting point for determining value would be a well-defined and universally available benchmark that is easily verified with a minimum of effort (Point 6 on attached chart).
2. Substantially reduce and simplify coal producer compliance costs in that a simple mechanical calculation would be all that is necessary to remit royalties. It would not be necessary to wade through and/or submit volumes of contractual and financial data, most of which would generate more confusion than fact.
3. Royalty liability, most of which is ultimately paid by electric utility consumers would be a determinable amount not subject to major, unexpected fluctuations and audit changes.

4. Eliminate the arguments over what is and is not an arms-length contract because IRC 613 arms-length determinations are based upon the long standing, tested definitions. If these definitions work for Internal Revenue Service for federal percentage purposes, they should work equally as well for MMS and the coal industry for federal royalty purposes.

5. The calculation would be self policing in that it would be in the coal producer's best interest to maximize "gross income from the property" for depletion purposes, thus maximizing federal royalties. This would be so even though the depletion rate, now effectively 8%, is less than the current 12.5% royalty rate because, in the vast majority of cases, the royalty is reimbursed by the electric utilities while depletion accrues to the benefit of coal producers.

6. Eliminate the so-called "take-or-pay" issue because payments for under-utilized mine facilities are excluded from the depletion base by IRS, since they are not related to the ownership, mining or production of coal (Point 11 on attached chart).

7. Eliminate the offensive practice of applying federal royalty on itself because royalties are not included in the producer's depletable income (Point 10 on attached chart).

8. Eliminate the current MMS effort to impose royalty on new coal technologies and processes such as liquifaction, gasification and thermal drying. Such activities are deemed by IRS to be refining processes not related to mining or basic processing of coal and, therefore, not subject to depletion (Point 9 on attached chart).

9. Eliminate the need for an outbound transportation deduction because IRS regulations specifically prevent the inclusion of outbound transportation in depletable income. In-mine and pre-basic process transportation is included in depletable income (Point 12 on attached chart).

10. Greatly simplify the processing deduction (washing deduction in MMS proposal) by substituting a tried and tested allocation method found in IRC 613. Use of the depletion allocation method reduces the potential for abuse and, therefore, the need for restrictive percentage limitations (Points 7 and 8 on attached chart).

11. Eliminate the compounding of royalty on federal and state taxes and fees by providing a deduction for such levies because they reduce rather than enhance the value of coal (Points 4 and 8 on attached chart).

Justification

The use of "depletable income" as the starting benchmark for determining value in tandem with a fixed physical point of valuation will greatly streamline royalty administration. The result will be more accurate and predictable valuation with fewer disputes.

Use of the proposed cost driven price allocation method of calculating the processing deduction will substantially reduce the complexity of the calculation as proposed by MMS. The result will be improved auditability, predictability and fairness. The potential for excessive deduction is greatly reduced because the method proposed in the attached comments is an allocation of price as contrasted to the MMS proposal which is to calculate the allowance independent of price using a complex and unrealistic formula.

The proposed deductions for Black Lung Excise Tax, Abandoned Mine Land Fees and state and local taxes based on production adhere to the long established ad valorem concept that cost or price only equal value when established by the action of a free market. When the cost or price of coal is increased through the direct imposition of taxes, fees and royalties by government action, value is decreased, not increased. Federal coal becomes less competitive in the market place and less desirable as an income generator from the producer's perspective.

MMS recognized the inherent unfairness of imposing federal royalty on Black Lung Excise Tax and Abandoned Mine Land Fees noting that government could increase its royalty by increasing taxes and fees. The same logic applies equally as well to state severance tax and even moreso to the imposition of royalty upon itself.

Allowing price driven taxes, fees and royalties to cross-apply, each upon all the others, causes the effective rate of each to substantially exceed original legislative intent. We strongly assert that such practices are poor public policy that will negatively impact the development and production of federal coal, in the long term. If there is economic or political justification for the imposition of, or increase in a government levy, legislative bodies should act accordingly. Allowing price driven levies to compound upon themselves, and each other, substantially increases such levies outside the legislative process. We submit that prudent public policy should be that all governme imposed taxes, fees and royalties should stand independently on their own merits and be imposed, increased or decreased without interrelated impact.

Conclusion

The MMS proposal in reality ignores basic ad valorem concepts and substitutes totally inappropriate "gross income tax" concepts. If Congress had intended to levy minimum ad valorem royalties in excess of 12.5% (8% for deep coal) or a "gross income tax" on the receipts of mining companies, it would have so indicated. Clearly, Congress did not intend such results. The intent was to levy a royalty on the value of coal actually produced from federal leases.

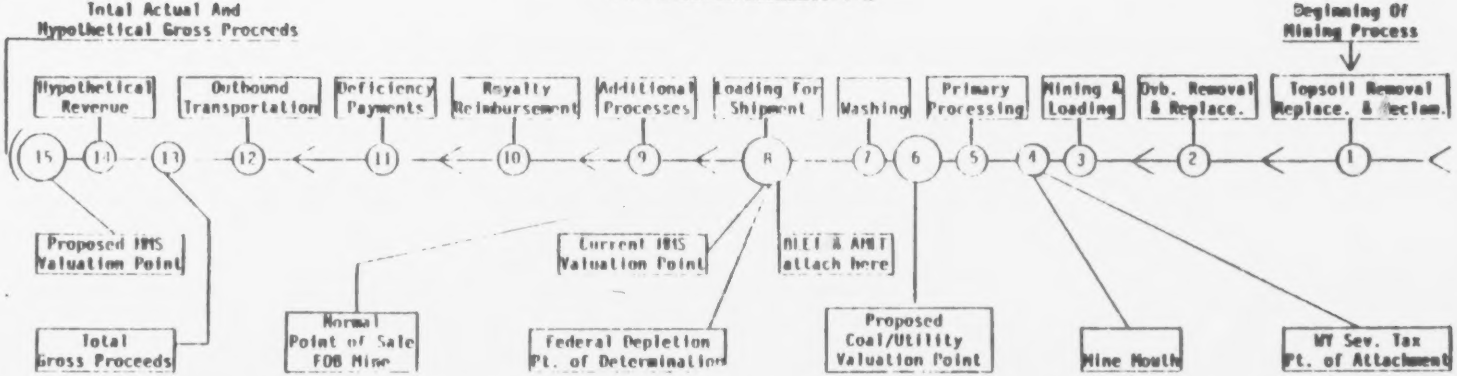
The attached flow chart visually summarizes the significant issues related to coal royalty valuation. The example mine depicted on the chart is a Wyoming, Powder River Basin, surface mine. Generally, most of the issues are common to all mines.

The advantages of the coal/utility industry proposal in terms of legislative intent, appropriate public policy, administration and fairness are exceedingly obvious. The result would be a smoothly operated royalty program which would be in everyone's best interest. We urge MMS to adopt the depletion based federal coal royalty valuation program set forth in the following comments.

7/013
attachment

FEDERAL ROYALTY VALUATION COMPARISON

Wyoming Surface Mine Example


Total Actual And
Hypothetical Gross Proceeds
Beginning Of
Mining Process
Hypothetical Revenue
Outbound Transportation
Deficiency Payments
Royalty Reimbursement
Additional Processes
Loading For Shipment
Washing
Primary Processing
Mining & Loading
Ovb. Removal & Replace.
Topsoil Removal Replace. & Reclam.
15
14
13
12
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2
1
Proposed MMS Valuation Point
Total Gross Proceeds
Normal Point of Sale FOB Mine
Current MMS Valuation Point
Federal Depletion Pt. of Determination
NIEI & AMT attach here
Proposed Coal/Utility Valuation Point
Mine Mouth
WY Sev. Tax Pt. of Attachment

(1)(2)(3) Basic surface mining functions -- comparable functions occur in a deep mine.

(4) Point at which coal reaches surface or level grade. Wyoming severance tax liability is determined at this point.

(5) Crushing and sizing

(6) Coal industry believes royalty should attach and value be determined at a defined point at which coal achieves marketable condition (after primary processing).

(7) Traditional coal washing (seldom done in Powder River Basin).

(8) Federal depletable income is determined at this point. Gross proceeds related to any process, function or activity occurring after this point is non-mining and not subject to statutory depletion. Black Lung Excise and Abandoned Mine fee attached at this point. Existing MMS regulations determine value at this point.

(9) Additional processes (liquifaction, gasification, thermal drying) using marketable coal as feedstock.

(10) Federal royalty reimbursement included in coal purchased under long-term coal supply agreements.

(11) Payments for under-utilization of mine facilities when purchaser is unable to accept coal.

(12) Outbound transportation may be included in price when quoted on a delivered basis.

(13) Total receipts for functions and activities to this point equal total actual mining and non-mining income received by coal producer.

(14) MMS proposes to add to actual gross proceeds any amount they determine could have been charged the purchaser without regard to actual market results.

(15) MMS proposed valuation point includes both real and hypothetical revenue, reduced by: partial deductions for outbound transportation; additional processes and washing; full deductions for Black Lung Excise Tax and Abandoned Mine Land Fees.

October 13, 1987

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RE: REQUEST FOR COMMENTS ON THE JOINT INDUSTRY ALTERNATIVE TO THE MMS PROPOSED COAL PRODUCT VALUATION REGULATIONS RELATED TOPICS, 43 CFR Part 3480

Dear Mr. Whitcomb:

These comments are submitted in response to the request for comment, appearing in 52 Fed. Reg., No. 155, at page 29868, on the joint industry alternative to the MMS proposed coal product valuation regulation.

As principal proponents of the joint industry proposal we continue to believe that our alternative is far superior to the MMS proposal both in terms of efficiency and administration. We find it to be in the beneficial interest of the states, tribes, coal producers and federal government. While disagreement over what deductions are appropriate exists, none should disagree that it is far superior to develop a program weighed heavily on administrative simplicity and low on manpower needs. We believe our proposal, which can be effectively and efficiently administered with a minimum staffing requirement, as opposed to perhaps the hundreds needed to administer the MMS proposal, will benefit both the public and private sectors.

The Joint Industry Proposal embraces three fundamentally sound valuation concepts which are:

1. The use of an already established, universally available, well defined benchmark as the starting point for the valuation process, which is gross income from the property as defined by Internal Service Code Section 613 and related regulations - commonly referred to as depletable income.
2. The use of a fixed physical valuation point at which all federal coal would be valued.
3. The application of valuation adjustments to convert producers' gross income to the value of produced coal.

Depletion Benchmark

The depletable income benchmark is proposed because it is consistently calculated by each coal producer on a mine specific basis and is arrived at in accordance with long standing Internal Revenue Service regulations. In simple terms, depletable income is the arms-length selling price of produced coal F.O.B. mine. The alternative proposal by the Minerals Management Service is based upon the gross proceeds of the mining company on a contract by contract basis which requires the accumulation of considerable information that does not exist in any one place.

Fixed Valuation Point

Using a fixed valuation point eliminates confusion over what is or is not included in value and is much more fair to competing coal producers as compared to the floating valuation point proposed by MMS. The industry proposal would value coal for royalty purposes immediately after the product has been crushed and sized (which, in the vast majority of cases, is when coal from federal leases achieves marketable condition). The proposed valuation point would also prevent the application of royalty to value added by new coal technologies such as liquifying, gasifying and thermal drying.

Valuation Adjustments

The valuation adjustments contained in the Joint Industry Proposal remove Black Lung Excise Tax, Abandoned Mine Land Fees and state severance taxes from the mining companies' gross receipts to arrive at the value of produced coal. Direct federal or state levies upon coal, which frequently can total more than 40% of its cost, may each have merit individually. However, the imposition of such levies upon coal, without enhancing its quality or desirability in the marketplace, does in fact, reduce -- not increase -- its value. The point is that if an individual levy is imposed at a given rate, it should not be allowed to escalate beyond legislative intent due to interaction with a combination of several other government levies, taxes and fees. Each levy imposed by the government should stand on its own merits and be collected at the prescribed rate. Administrative procedures should not be allowed to increase such levies through continuous cross compounding to infinity.

MMS has partially recognized the inherent unfairness of cross compounding by proposing deductions for Black Lung Excise Tax and Abandoned Mine Land Fees. States also have recognized this problem to a degree. For instance, Montana deducts state severance and government royalties to arrive at severance tax value. Wyoming deducts government royalties and post marketable condition handling value for severance tax purposes. The Joint Industry Proposal carries this concept to its logical conclusion by providing for the removal from the base of the royalty itself and state severance taxes based on production as well as Black Lung Excise Tax and Abandoned Mine Land Fees.

Administration

The administrative simplicity of the Joint Industry Proposal is obvious. Valuation would be clearly defined, based on a pre-existing benchmark and sound valuation techniques. Producer compliance and MMS audit work would be on a mine by mine basis using existing rules and available information as opposed to a contract by contract approach based on new and different rules. Since depletable income is virtually always audited by Internal Revenue Service, MMS would enjoy an additional level of comfort as to the reliability of producer compliance. There is a natural policing aspect of this proposal in that coal producers will maximize depletion.

Because the proposal makes the benchmark for starting the royalty valuation process consistent with the definition of depletable income found in the Internal Revenue Code as of a specific date, January 1, 1987, MMS would have the option to update its regulations should Congress or Internal Revenue Service change depletion rules prospectively. In the rare situation where a federal coal producer is selling coal so far below cost that he does not bother to calculate depletion, a sound set of rules upon which to base value would still be in place.

The depletion based proposal is not a new idea. The Commonwealth of Kentucky has used this approach for several years in the administration of its ad valorem severance tax, with highly satisfactory results. Kentucky's administration is simple and highly efficient. Audits involve tying in monthly reports with annual federal income tax returns, checking to see that gross income from the property was properly determined, and reviewing IRS audits for changes in depletable income. The effectiveness of the Kentucky system is an established fact.

Attached are more detailed comments in support of the joint industry proposal as well as suggested regulatory language where appropriate.

We urge you to give serious consideration to our proposal.

Sincerely,

William McCollam, Jr. Richard L. Lawson John

WILLIAM MCCOLLAM, JR.	RICHARD L. LAWSON	JOHN A. KNEBEL
PRESIDENT	PRESIDENT	PRESIDENT
EDISON ELECTRIC INSTITUTE	NATIONAL COAL ASSOCIATION	AMERICAN MINING CONGRESS

COAL ROYALTY VALUATION ISSUE ANALYSIS

Joint Industry Proposal

The joint industry proposal embodies three distinct concepts, the application of which would result in the following:

Depletable Income As Benchmark Valuation Starting Point

1) **Administrative complexity** - compliance and auditing based on existing depletable income information at mine level would be more efficient and less costly than the use of contract by contract gross proceeds information level that must be accumulated.

2) **Optimum compliance results** - producer will maximize depletion at expense of higher royalty (producer keeps depletion, customer pays royalty). IRS audits depletable income.

3) **New coal technologies** - liquifying, gasifying and drying would not be subject to royalty. IRC does not allow these items to be included in depletable income, because they are not the result of mining.

4) **Royalty compounding upon itself** - IRC precludes depletion of royalty by coal producers. Industry proposes to add all royalties except federal to depletable income for federal royalty valuation purposes.

5) **Separate arms-length pricing determinations** not necessary. IRC provides well established guidelines to convert "captive" prices to arms-length for depletion purposes.

6) **Outbound transportation** deduction not necessary. IRC precludes depletion of o.b.t. and provides mechanism for removal to arrive at depletable income, if necessary.

7) **Hypothetical revenue** (payments for underutilization of mine facilities, uneconomical -- lost production, etc.). IRC does not allow these items to be included in depletable income, because they are not generated by coal production.

Fixed Physical Valuation Point

1) **Greatly reduce disputes over what processes** should be included in royalty valuation.

2) **Complex "washing allowance"** replaced with simple, efficient "processing allowance" mechanism not subject to abuse.

3) **Reduce inequity between producers** because all coal would be valued at the same physical point -- when marketable condition is first achieved.

4) **Reinforces** point that value added by new coal technologies are not subject to royalty because they occur after the point of valuation.

Valuation Adjustments (Black Lung, AMLF, Severance Tax)

1) **Converts producers gross income into product value.**

2) **Separates dual roles of government** as landlord and public policy maker. Allows each fee or tax to stand on its own at the prescribed rate, and not be artificially increased by cross compounding.

3) **Removes compounding effect of federal taxes and fees** interacting with royalty imposed by same legislative body.

4) **Removes compounding effect of royalty on state severance taxes** imposed by the states who receive the largest net share of federal royalty revenue.

Criticisms and Responses Thereon Relative To The Joint Industry Proposal

The depletion based Industry Valuation Proposal will not be significantly more efficient or less expensive to administer than the MMS gross proceeds proposal.

Federal coal is currently produced from approximately 80 mines by approximately 60 companies and sold under more than 200 contracts. Royalty calculation under the Industry Proposal would be done approximately 80 times by all coal producers in each reporting period based upon pre-existing, mine level, information that has generally been accumulated in the proper format, requiring relatively little modification. Under the MMS proposal, a separate calculation of gross proceeds generated by each of more than 200 contracts will be necessary. This will initially involve the analysis of the original contract and each price adjustment from the beginning of the contract through the end of the reporting period to build up the total price received or that could have been received in the current period.

Records necessary to determine and verify royalty value under the Industry Proposal for each of the 12 monthly reporting periods in a calendar year could easily fit into a normal size briefcase. Such records would include, but not necessarily be limited to, the federal income tax return, the certified financial statements and mine operating statements (including cost detail). The records necessary to calculate and verify accumulated gross proceeds using the MMS contract by contract gross proceeds approach could easily fill several file cabinets. Not only are the contracts unique and voluminous, but each individual price adjustment (frequently done quarterly) may involve several hundred pages of calculations and support detail.

The following example illustrates the simplicity and efficiency of the Industry Valuation calculation. The hypothetical mine is a large Powder River Basin surface operation producing 800,000 tons per month, sold for a weighted average price of $10.00 per ton under 5 long term coal supply agreements.

Federal Royalty for the reporting period would be determined as follows:

		(000 Omitted)
	Total Gross Income from the Property (800,000 tons @$10)	$ 8,000
	Deduct: Federal Royalty	(677)
(a)	Private Royalty	(54)
(b)	Gross Royalty Value (Producers Depletable Income)	$ 7,269
(a)	Add Private Royalty	54
(c)	Deduct: Processing (Post Marketable Condition)	(328)
(d)	Black Lung Excise Tax	(337)
(e)	Abandoned Mine Land Fee	(280)
(f)	State and local production Tax	(960)
	Net Royalty Value	$ 5,418
	Federal Royalty @ 12.5%	$ 677

(a) 1% of selling price less all royalties and direct government taxes and fees.

(b) This amount, combined with like amounts from all other reporting periods months in the tax year will match depletable income reflected on the producers federal income tax return depletion schedule, if both are correctly calculated.

(c) Gross royalty value of \$7,269 x $\frac{\text{Post Marketable Cond. Cost \$289}}{\text{Total Depletable Cost \$6,400}}$ = \$328

(d) (4.4% of \$8,000)÷104.4% (federal excise tax does not compound upon itself)

(e) 800,000 tons @ \$.35

(f) 15% of (sales less deductions of 20%)

The calculation of royalty liability for the same reporting period using the MMS proposed gross proceeds concept would require separate selling price build-up for each of five unique contracts to be multiplied by quantity produced and sold to each customer in the reporting period from the federal lease to arrive at liability. Verification of these calculations would involve at least the following steps:

1. Ascertaining the accuracy of each price adjustment from the inception of the contract through the end of the reporting period.
2. All proceeds flowing from each contract that are not related to the production of coal would have to be identified and included, even though they are not normally treated as part of mining income.
3. Since the MMS proposal is based upon a floating valuation point, it would be necessary to calculate and remove part of the value of outbound transportation and washing pursuant to complex and unrealistic netback rules that will seldom yield a proper result.
4. The value of foregone production must be ascertained and added to the value of coal actually produced from the federal lease.

Based upon audit experience discussed later in these comments, the initial field audit of this producer by MMS would take 900 man days, assuming the 5 contracts had been in place for an average of 4 years:

(45 man days/4 years/5 contracts = 900)

Subsequent annual audits would take 225 man days:

(45 man days/1 year/5 contracts = 225)

If compliance is depletion based, on a mine by mine basis, the audit of a year's activity would take no more than 10 man days. The large difference is due to the fact that depletion based valuation utilizes existing information that is repeatedly verified and scrutinized by multiple groups of auditors.

Depletion based valuation is a new and untested idea.

Depletion based ad valorem valuation is not a new idea. This methodology has been in place and working in the Commonwealth of Kentucky for more than 15 years. The result has been a high degree of compliance with a minimum amount of administrative cost, including personnel. Kentucky raised approximately $200 million annually in revenue from depletion based coal severance tax paid by approximately 1,200 coal producers, using 15 people including administrative and support personnel. Because depletion based value is so clearly defined, there are very few disputes. Approximately $7 million is currently being litigated in Kentucky for all years. On average, disputed annual liability is substantially less than 1% of collections.

We believe if the Kentucky experience is a fair indication of the effectiveness of a depletion based program. Accordingly, the relatively small federal coal royalty program involving approximately 80 mines operated by approximately 60 companies could be administered with no more than 10 qualified personnel. To be specific, with a 3-year statute of limitation and 60 companies mining federal coal, it would only be necessary to audit 20 companies each year doing 36 month audits in each case. If qualified financial accounting trained auditors are used, three teams of two each could audit six or seven companies each year with ease. In addition to six auditors, it would be necessary to have three or four support personnel to process and math check report forms and administer the program.

Gross proceeds is a more effective and efficient administrative procedure because it is based on the coal supply contract.

It is true that the MMS gross proceeds concept is in part based on the contract. In theory, if all contract terms and subsequent price adjustments are properly interpreted by an auditor, and all costs properly accumulated, the end result will be similar to depletable income except for the inclusion of federal royalty, new coal technology value and possibly deficiency payments. The problem is that it takes an inordinate length of time to arrive at that point using gross proceeds methodology.

Evidence of the efficiency of a depletion based approach can be found in the Kentucky system as previously discussed. Evidence of the time-consuming nature of gross proceeds auditing can be found in the contract administration relationship between coal producers and utility customers. Virtually all utilities field audit coal pricing annually to verify accuracy. Due to the nature of the audits, contract specific gross proceeds methodology is the most appropriate procedure.

Discussions with several coal producers and utilities confirm that it takes approximately 45 man days to audit one year's activity and a substantial additional amount of time to write up the report.

We know that there are more than 200 coal contracts supplied from federal leases and that many of them have been in force for several years. For discussion purposes, assume 200 contracts in force for an average of 4 years each. Based on the audit experience of utility coal buyers, the first year's audits would take 9,000 man days, or at least 164 auditors, based on 220 work days/year allowing no time for report writing or other work. In addition, substantial numbers of support personnel would be needed to handle the huge volume of paperwork. In subsequent years, audit time would be reduced because only one year's activity would be examined. However, there would still be a need for at least 50 auditors, plus support personnel. Contrast these results to the ten people needed to administer a depletion based program based on experience in Kentucky. These projections do not take into account the fact that additional time will be required to write up reports.

The comparative efficiency of a depletion based royalty valuation and administration system is obvious. The inefficiency of a contract specific gross proceeds approach is equally obvious.

Depletable income is a build-up of cost or attributed income and, as such, would be difficult to verify.

Depletable income is neither a cost build-up or a collection of attributed income. Total depletable income for a coal mine is the arms-length selling price of produced coal in marketable condition, F.O.B. mine. This amount becomes the starting point for a coal producer's tax return, including the depletion schedule, virtually all financial accounting records and the certified financial statements. This amount is routinely audited by government agencies, customers, internal auditors and external auditors. This amount is one of the most readily available and consistently calculated pieces of information that exists within the records of a coal producer.

The major difference between depletable income and gross proceeds is that depletable income is intended to include only the market value of produced coal that has been mined and processed to the point that it has become marketable. This contrasts with MMS contract specific the gross proceeds concept which involves the build up of several separate elements of value including additional processes beyond the first point of marketability, receipts not related to coal production and hypothetical receipts related to sales or production that never occurred.

Why should we convert to a new valuation method when we are familiar with the tried and tested gross proceeds approach that was developed by several states in the administration of severance taxes?

It is true that the gross proceeds concept has been developed over several years by states principally for the purpose of administering mineral severance taxes. However, the concept of a royalty is not as broad as the concept of a tax levied for the privilege of conducting an activity such as mining. A royalty is intended to be a share of production while a privilege tax is paid for the right to mine and can be measured by any means desired. If government chooses to levy a tax for the privilege of mining, such a tax can be measured by gross receipts, net income, capital investment, weight, volume, number of employees, or any other appropriate means. On the other hand, a royalty is not a gross receipts or privilege tax. A royalty relates to production of the mineral up to the first point of marketability, not all of the activities of the mining company.

Depletion based valuation rules are too restrictive and rigid, providing little opportunity to deal with unique or unusual problems.

The depletion based valuation proposal, including the mechanical calculations necessary to arrive at net royalty value, are intentionally precise and rigid. We believe valuation rules should eliminate as much latitude from the valuation process as possible. Precise rules and efficient administration equate to equity in the treatment of lessees, which should be a high priority with MMS.

One of the major flaws in the gross proceeds concept is that there is too much latitude for both coal producers and MMS to exercise discretion, thus creating inequity. The majority of coal producers who operate in states where severance taxes are calculated based on gross proceeds methodology are convinced that seldom are two coal producers treated alike. While it is a generally accepted fact that the exercise of discretionary authority on the part of public administrators equates to power, it is equally true that the result is poor administration. Consistency, uniformity and equal treatment of coal producers must be an integral part of the MMS coal royalty program, if it is to succeed.

The Internal Revenue Code and related regulations are difficult to understand.

It is true that the Internal Revenue Code and regulations are voluminous and often verbose. It must be kept in mind that the Code has been developed over a long period of time, serves many and sometimes conflicting interests and is very technical in nature. However, the depletion rules have not followed the same pattern as the Code in general. The basic fundamental concepts upon which the calculation of depletable income is based have not significantly changed since its inception many years ago. Currently, there are very few disputes over what is or is not depletable income to a coal producer.

The same cannot be said for gross proceeds programs as they relate to government levies upon coal at either the state or federal levels. Valuation disputes are more the rule than the exception. Guidelines are difficult to write in precise detail and even more difficult to follow. The resulting inconsistency is not just totally related to the weakness of gross proceeds valuation. Coal supply agreements are more often different than they are alike. The combination of gross proceeds complexity with the unique nature of coal supply agreements equates to unending chaos, serving only the interests of those who benefit from large government and protracted litigation.

If a coal producer is selling coal below cost, thus generating no profit, the producer may not calculate depletable income. Therefore, since there is no depletable income there would be no federal royalty due.

This is not a correct reading of the Industry Proposal. The proposal is specifically designed to prevent this kind of occurrence. The proposed definition of gross royalty value is synonymous with the definition of depletable income found in the Internal Revenue Code. Gross royalty value equals depletable income only when depletable income is correctly determined. If a producer fails to calculate depletable income or incorrectly calculates depletable income, MMS would have the right and, in fact, the responsibility to make appropriate corrections. Even under these unusual circumstances, the existence of a long standing set of rules will make the construction or correction of gross royalty value much easier than by using contract specific gross proceeds methodology.

Coal producers don't comply with Internal Revenue Service depletion regulations.

This false allegation is an obvious attempt to discredit the depletion based valuation proposal and divert attention from the real issues. Compliance with any tax is probably never 100%. However, the Internal Revenue Service pays particular attention to tax preference items such as depletion when conducting audits. The result is a higher degree of forced compliance in the tax preference areas than with general tax provisions. Although the non-compliance allegation is without merit, it is interesting to point out that if coal producers are not complying with Internal Revenue depletion rules, it would mean that they are inflating depletable income. If this were true, federal royalties would be increased, not decreased.

Coal producers would "play" with depletable income to lower federal royalty liability.

Coal supply agreements, virtually without exception, do not provide for the pass through of federal income tax benefits to the coal purchaser. Conversely, the vast majority of coal supply agreements do pass federal royalty costs through to purchasers. It therefore follows that coal producers will maximize depletion (which is their benefit to keep) even at the expense of increasing the federal royalty (which is passed through to the customer).

The Industry Proposal does not provide a mechanism for segregating production on a federal lease from non-federal production at the same mine.

This is a valid criticism. The Industry Proposal, like the MMS proposal, does not provide an adequate mechanism for segregating or allocating co-mingled federal and non-federal production at the same mine. To correct this deficiency, we propose the following language which provides for a precise segregation or allocation of federal production based upon readily available information. In general, the proposed allocation mechanism would be based upon tons produced from each federal lease as a percentage of total mine tons, and would only be used when actual segregation is not possible. Additionally, BLM requires that an independent third party prepare and the lessee file segregated production reports from all sources be they federal, state or private leases.

SUGGESTED REGULATORY LANGUAGE

Add a new section 206.255(d) to read as follows:

FEDERAL PRODUCTION SEGREGATION

(A) When total production from a single mine includes production from more than one federal lease or production other than from a federal lease, gross and net royalty value of coal produced from each federal lease must be segregated from other production at the mine on an actual basis to the extent possible.

(B) When production from a mine includes coal from more than one federal lease or production other than from a federal lease, and total mine production is so co-mingled as to preclude segregation and separate identification of the federal portion of gross royalty value, net royalty value or any component thereof (except royalties), such value or components shall be determined in accordance with the following allocation procedure:

> The component being allocated shall be multiplied by a fraction, the numerator of which is the actual number of tons produced from the federal lease in the reporting period, and the denominator of which is the total actual tons produced from the mine in the same reporting period.

The allocation computation may be illustrated by the following:

Surface Mine Example

Assumptions:

- Total mine production for reporting period 1,000,000 tons (800,000 federal, 200,000 private)
- Total mine production sold for $10/ton
- Separate federal and private production are not physically distinguishable
- Federal royalty rate 12.5% of net royalty value
- Private royalty rate $.50/ton
- Overriding royalty applicable to all production
- State severance tax rate of 15% applicable to selling price reduced by various deductions equal to 20% of the selling price
- Total product cost $8,000,000, post-marketable condition portion $361,000 (80% = $6,400,000 and $361,000 respectively)

federal royalty for the reporting period would be determined as follows:

		(000 omitted) Federal	Private	Total
	Total Gross Income From The Property	$ 8,000	$ 2,000	10,000
	Deduct Royalties - Federal (actual)	(677)		(677)
	- Private (actual)		(100)	(100)
	- Override (actual)	(54)	(17)	(71)
(a)	Gross Royalty Value - Federal Coal	$ 7,269		
	Gross Royalty Value - Private Coal		$ 1,883	
(b)	Producers Gross Income From The Property			$ 9,152
	Add: Federal Portion of Override	54		
(c)	Deduct: Processing Allowance	(328)		
(d)	Black Lung Excise Tax	(337)		
(e)	Abandoned Mine Land Fee	(280)		
(f)	State Severance Tax	(960)		
	Net Royalty Value	$ 5,418		
	Federal Royalty @ 12.5%	$ 677		

Allocation Factor $\frac{\text{800 Federal Tons}}{\text{1,000 Total Tons}} = 80\%$

Footnotes

(a) Gross royalty value equals 80% of actual gross income from the property reduced by actual federal and overriding royalty

(b) Producers depletable gross income from the property determined pursuant to IRC 613 in effect 1-1-87

(c) $\$7,269 \times \frac{289}{6,400}$ (removes post-marketable handling value)

(d) 80% of $\left(\frac{10,000 \times 4.4\%}{104.4\%}\right)$

(e) 800 tons @ $.35/ton

(f) 80% of $1,200 actual severance tax

(C) The allocation provisions of Subsection B of this section do not apply to the deduction of royalties from gross income from the property to arrive at gross royalty value pursuant to Section 206.251(k) or the addition of non-federal royalties to arrive at net royalty value pursuant to Section 206.251(k). These components of value must be separately identified and reported for each federal lease on an actual basis.

Internal Revenue Service often keeps the statute of limitation open with respect to corporate income tax longer than three years. Therefore, a change in depletable income after the industry proposed three-year statute of limitation has lapsed would not allow MMS to make a corresponding change in royalty value.

> This is a valid criticism. To correct this deficiency, we propose that a limited extension of the three-year statute of limitation be provided only with respect to depletable income issues that have been raised but not resolved in an IRS audit. The following language would provide such a limited extension of the statute of limitation:

SUGGESTED REGULATORY LANGUAGE

Add the following at the end of Section 206.253(g) (from Industry Proposal):

Final MMS audit determination shall be deferred when IRS has audited the lessee's federal tax return for any portion of the same period and the results have not been finally determined with respect to "gross income from the property" as defined by Internal Revenue Code Section 613(c). When such IRS audit results are finally determined, and all appeal rights have expired, the lessee shall forward a copy of the applicable portion of the determination to MMS within 30 days. MMS shall review the final IRS audit results and issue a final royalty audit report within 60 days following receipt of final IRS audit results.

Royalty administration personnel are uneasy about using another agency's guidelines as the basis for their administration.

> Decisions such as this should be based upon total government efficiency and cost. If this abstract concern is really an insurmountable problem, a definition of gross royalty value that does not reference the Internal Revenue Code could be constructed that is still synonymous with the depletable income definition. For instance, depletable income is equal to:
>
> the arms-length selling price of produced coal in marketable condition, F.O.B. mine.
>
> Using the above as the definition of gross royalty value, combined with realistic market definitions of arms-length, selling price, produced coal and marketable condition could yield an independent set of rules that are synonymous with depletable income so as to use simple compliance methods and provide MMS with solid information that can be audited by MMS and other public or private interests.

The appropriate basis for federal coal royalty is gross proceeds of a mining company with absolutely no deductions. MMS is "giving away the store" when it proposes deductions such as washing, outbound transportation, Black Lung Excise Tax and Abandoned Mine Land Fees.

> Taxes levied by states on mineral production are generally based upon the broad concept of causing mineral producers to pay for the privilege of

producing, as compared to the relatively narrow concept of a royalty as being a share of production.

Even though a privilege tax lends itself more to gross proceeds administration than does a royalty, several states have departed from the taxation of absolute gross proceeds. For instance:

- o Wyoming provides a deduction for all value added after the mine mouth, including the value of all processing or handling without regard to the type. Also, Wyoming allows gross proceeds to be reduced by total federal and state royalties for purposes of determining taxable value.
- o Montana provides a deduction for state and federal production taxes in determining taxable value so as to prevent the compounding of severance tax upon itself and other production taxes. Montana also allows a deduction for the vast majority of federal, state and Indian royalties in arriving at taxable value.
- o New Mexico reduces gross value by the amount of all government rents and royalties to arrive at severance tax value.

The logic espoused by some that deductions such as those allowed by the states for tax purposes are inappropriate as applied to the more narrow royalty concept escapes us. It would seem that _if_ these ideas are valid in the calculation of ad valorem mineral taxes at the state level, they are even more valid in the calculation of ad valorem royalty value at the federal level. The apparent answer to this inconsistency is that it is much easier to promote maximized near term revenue without regard to logic or long term consequences when the program in question is administered by a federal agency. We strongly assert that consistency, efficient and fair administration are priorities that should precede revenue or political considerations.

Federal royalties can't be administered based upon a tax or accounting concept because current administrative personnel are not accounting oriented.

This may be a valid criticism to a degree. However, regardless of the methodology ultimately built into MMS regulations, the determination of royalty value is in fact an accounting exercise. Ultimately, if accurate ad valorem royalty administration results are to be achieved, those who do the work -- both compliance and administration -- must have financial accounting training to interpret financial accounting data, which is the only realistic source for revenue and cost information.

Royalty administration using the depletion based approach will be more expensive than using gross proceeds.

The Kentucky experience is the best evidence that this is, in fact, not the case. Administrative expense would only be increased if additional, accounting oriented personnel, were hired to administer the coal royalty program.

The intent is to administer the coal royalty program using the same personnel and concepts as have been applied in the past in the gas and oil royalty program.

This is an error in judgment that must be corrected if the coal royalty program is to succeed. The similarity between gas and oil on the one hand and coal on the other, ends with the fact that each is a fossil fuel and are substitutes for each other under certain circumstances. Coal royalty administrative personnel should not be gas and oil people; they should be accounting oriented administrators who are familiar with the unique nature of the coal business. As pointed out earlier, a coal royalty program could be effectively and efficiently administered with only a handful of people, if they are the right people.

Depletion based valuation can't be used for coal because gas and oil lessees will want the same thing.

The vast majority of gas and oil is produced and sold at a field or regional market price. In the short run, the cost of production is not a direct pass through as is generally the case with coal. Field pricing is the most efficient and appropriate benchmark for oil and gas royalty valuation because it is the most accurate reflection of market value and the most readily available information. Likewise, depletable income is the best starting point for coal royalty valuation because it is the best indication of market value and is the most readily available information.

As we have often stated, coal is not oil and gas. Coal is not produced in the same manner as oil and gas. Coal is not sold in the same manner as oil and gas. Coal is not transported in the same manner. The point is that coal is different and unique and should be treated accordingly.

Royalty compounding upon itself can't be eliminated for coal without doing the same thing for oil and gas.

Royalties are not generally directly transferred to oil and gas purchasers as a cost of reimbursement. Therefore the royalty does not normally compound upon itself in a oil and gas price as it does in a typical coal sale where the royalty is in fact directly and totally reimbursed in the vast majority of cases. For purposes of illustration, assume equal units of gas or oil and coal sold for $10.00 and a new 12.5% federal royalty is imposed. The following example illustrates the difference.

	One Unit of Gas/Oil	One Unit of Coal
Pre Royalty Selling Price	$ 10.00	$ 10.00
Fed. Royalty Price Increase ($10 @12.5%)		1.25
Compounded Royalty (12.5% of 12.5% to Infinity)		.18
Post Royalty Selling Price	$ 10.00	$ 11.43

The imposition of federal royalty on gas or oil becomes an additional cost. Price does not change until the prevailing field or market price changes.

Under the provisions of most federal coal supply agreements, the federal royalty increases price as well as cost. Therefore, using the MMS gross proceeds concept, the increased price is subject to a royalty. Total federal coal royalty becomes $1.43 compared to $1.25 on the same gas/oil value unit, an effective 14.3% royalty on coal compared to 12.5% on gas/oil.

Deducting federal royalty to arrive at coal royalty value places coal on the same footing as gas and oil.

Because coal is not gas and oil and is not sold, produced, transported or priced like gas and oil, the difference in treatment is justified.

Additionally, we do not propose to argue the merits of the treatment of federal gas and oil producers. We would, however, make the comment that if gas and oil producers are paying excessive federal royalties due to compounding of the royalty upon itself or any other government tax or fee, excessively charging coal producers for the sake of consistency compounds rather than corrects the problem. If there are problems with gas and oil valuation, they should be independently evaluated and corrected. We submit that coal is so vastly different than gas and oil that royalty administration, of necessity, will be equally different if it is to be successful. Decreeing by regulation that coal is the same as gas and oil is like decreeing that the sun rises in the west. Regulations, even though they may have the force and effect of law, can't change reality.

The industry proposed fixed valuation point (defined point of first marketable condition) will deprive the government of revenue.

The concept of a royalty is not the same as the concept of a tax that raises revenue. A royalty is supposed to be a share of the mineral owned by the lessor. Once that mineral has been extracted and brought to marketable condition at no cost to the lessor, that lessor has no right to any value that is attributed to or added to that product after that point. MMS clearly indicates in its proposed regulation that royalty is due on coal that has achieved marketable condition without regard to whether it is actually sold. Using the same logic, it follows that once marketable condition has been achieved and royalty becomes a lien, it should not be increased by activities occurring after the point of attachment. To attempt to do so converts the concept of a royalty into a gross income tax.

We do not believe Congress intended federal royalty to be a gross income tax. We assert that the original concept of a royalty be adhered to by rigidly defining a physical point at which coal achieves marketable condition and determining value at that point, excluding any value added or subtracted subsequently. Since marketable condition of most federal coal is achieved after the coal has been crushed and sized, value should be determined at that point. It is inappropriate to attach liability at one point in the production process and measure value at another.

Long term coal supply agreements are pipelines through which revenues flow to coal companies and governmental units. Increases in that revenue stream through increased government levies is in the best interest of coal producers as well as governmental units.

> This notion could not be more unrealistic. The preservation of long term coal supply agreements through prudent cost control, both by producers and lessors, is very much in the best interest of both. If direct government levies were a relatively minor part of the cost of coal, the impact of government policy making would not be significant. Unfortunately, this is not the case. With the application of a 12 1/2% federal coal royalty, the direct federal and state government generated portion of total coal cost can easily exceed 40%. Due to this nearly equal partnership, it is incumbent upon the government to exercise as much cost control prudence as does the lessee. To the extent that long term coal supply contracts are aborted and lower prices result or alternative fuels are used, both the lessor and the lessee are major losers. It is, therefore, in the best interest of both not to take actions that promote such undesirable results.

The Industry Proposal is a "package" that must be accepted or rejected in total.

> While we believe the industry proposal is much more closely aligned with legislative intent in terms of valuation and efficiency, the proposal is based upon three basic severable concepts which are:
>
> - Depletable income as the valuation starting point;
> - A fixed physical point of valuation;
> - Valuation adjustments to convert producers' gross income into coal value.
>
> As illustrated by the preceding summary, the basic parts of the proposal function independent of each other, and would do so even if all of the proposal is not accepted.

Government-Imposed taxes and fees, such as Black Lung Excise Tax, Abandoned Mine Land Fees and state severance taxes, are costs that should be "internalized" and, therefore, included in coal royalty value.

> There are limitations on the relationship between cost and price. The universally-accepted ad valorem rule is that cost or price equal value only when determined by the action of a free market. If you apply this rule to coal royalty valuation, it is apparent that federal coal declines in value when direct taxes and fees are imposed.
>
> In economic terms, if the price of a product increases without a corresponding increase in the quality or desirability of the product, the value drops. The amount of value decline may be a very subjective issue, but not the fact that the decline occurred. The industry proposal does not intend to remove the subjective decline in value that results from the imposition or increase in government levies. It simply proposes that such levies not be included in the value, because they in fact add nothing to it.
>
> A good example of the price/value relationship can be seen in the following hypothetical case: If Washington, D.C. decided to impose a $500 annual fee

for the privilege of driving a private motor vehicle in the city for very good and worthy public policy motives related to traffic congestion and pollution, the value of an individual's car would simultaneously decline in the marketplace. The car could be sold to someone who is not driving in Washington, D.C. for the same price as prior to the imposition of the tax, but the market has been severely limited. If the owner tries to sell the car to someone who will be driving in the city, they will be more resistant to the price and less willing to pay the full amount because their cost of operation has increased (to pay for a worthy social cost).

Government is in a totally unique position with respect to federally-owned coal as both landlord and public social policy maker. Great care should be taken to separate these two functions. If there is merit in the imposition of a Black Lung Excise Tax or a Reclamation Fee or anything else in the future, then so be it. It is really stretching the point, however, to say that such nonmarket-generated cost or price increases enhance the value of federal coal when, in fact, the opposite is really the case.

One could construct a scenario that says government levies that are truly user fees for government services should be internalized. However, the vast majority of the funds collected by federal and state levies have nothing to do with services provided for producers of federal coal. Most of the Abandoned Mine Land funds are directed to areas other than federal leases. The Black Lung Excise Tax is levied disproportionately upon federal coal when the incidence of black lung disease is negligible, both in the past and currently, from mining on federal leases as compared to other mining areas. Wyoming state and local severance tax, for instance, funds approximately 70% of the total state and local operating budgets. Obviously, the mineral industry is not consuming 70% of Wyoming's state and local government services. In fact, what these levies represent are subsidies for other parts of the economy or other geographic parts of the United States, and as such could not possibly be adding to the value of federal coal. The "internalizing" of these costs is contemplated by the policy-making side of our two-headed landlord, which we believe is poor public policy. The appropriate policy should be that each government levy stand independently on its own merits and not interact with all other such levies to generate revenues in excess of intent.

**National Rural Electric
Cooperative Association**

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TESTIMONY OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Regarding Proposed Regulations of the
Minerals Management Service for Coal
Product Valuation and Related Topics

Presented to the Subcommittee on Mineral Resources
Development and Production of the
Senate Committee on Energy and Natural Resources

Senator John Melcher, Chairman

By

Girts Krumins, President
Colorado-Ute Electric Association, Inc.

Oversight Hearings, November 16, 1987

My name is Girts Krumins. I am the President of Colorado-Ute Electric Association, Inc. (Colorado-Ute), a not-for-profit rural electric cooperative headquartered in Montrose, Colorado. Colorado-Ute is a member of the National Rural Electric Cooperative Association (NRECA), and I am testifying today on behalf of both NRECA and Colorado-Ute. I want to thank you for this opportunity to address this Subcommittee and to state NRECA's concerns regarding the coal product valuation regulations proposed by the Minerals Management Service (MMS).

NRECA's membership includes 58 generation and transmission (G&T) cooperatives, which provide their distribution rural electric cooperative members with wholesale electricity. Approximately 75% of the installed generating capacity of these G&Ts is coal-fired. Many of the G&T members of NRECA, particularly those which, as with Colorado-Ute, are located in the West, obtain a large part of the coal supplies for their coal-fired generating plants from federal leases. Nearly all generating cooperatives have long-term coal supply agreements with royalty pass through provisions. Thus, the method used by MMS for coal product valuation has a severe effect on their costs. In turn, this affects the cost of electricity for their rural electric consumers.

Both NRECA and Colorado-Ute have previously participated in this MMS rulemaking, with both individual comments and as proponents of the joint coal and utility industry proposal submitted to MMS during July, 1987.

We believe that the industry proposal represents a reasonable compromise, and should be adopted by MMS without further delay.

While the use of a percentage royalty method is not at issue in this rulemaking, NRECA disagrees with the Bureau of Land Management's (BLM) onerous decision to apply the 12 1/2 percent ad valorem royalty (which applies to new leases) to leases issued before 1976. The 12 1/2 percent royalty is in itself severe, but to layer the additional fees and taxes into the base cost only makes a bad situation worse. The drastic royalty cost increases for G&T users of federal coal -- in Colorado-Ute's case, as much as nearly 2000 percent will result in substantially higher energy costs for rural electric consumers.

The 12 1/2 percent royalty unfairly taxes rural electric users of federal coal who had no idea that federal royalties would be increased by such huge amounts when they signed their original contracts -- many of which are 10 to 20 year agreements. This policy as an end result, puts an excessive tax on low-sulfur coal, which is valuable for its ability to reduce pollution. Any royalty formula or MMS regulation which is adopted should not further tax this valuable resource. Rather, federal policy should provide incentives for utilities which are already scrubbing low-sulfur federal coal to continue doing so, and to entice others to start doing so.

Nevertheless, MMS continues to impose its interpretation that even leases issued before the Federal Coal Leasing Amendments Act in 1976 must pay royalties on ad valorem basis (the 12 1/2 percent rate). We strongly support the July, 1987 industry proposal over the original MMS proposal. (See attached Exhibit A) The royalty-on-tax and royalty-on-royalty method proposed by MMS is contrary to the statutory directive to assess a 12 1/2 percent royalty only on the value of the coal produced, and increases the hidden federal tax on rural electric consumers.

we find the royalty-on-royalty treatment is particularly unfair. Prior to the imposition by MMS of the 12 1/2 percent royalty rate, the entire royalty on Colorado-Ute's federal coal was no higher than 20 cents per ton. The royalty-on-royalty treatment alone would add from about 30 to about 45 cents per ton to the cost of Colorado-Ute's federal coal -- up to 2 1/2 times the total previous per ton federal royalty -- if the application of a percentage royalty for that lease is upheld.

MMS would also place a royalty on other taxes and fees imposed on coal. The royalty should only be applicable to the intrinsic value of the coal as mined, and not to governmental fees and taxes, which add nothing to the value of the coal, although in most cases add substantial costs. The MMS proposal to exclude Surface Mining Control and Reclamation Act (SMCRA) and black lung fees from gross proceeds is a step in the right direction. State severance taxes, other fees and taxes, and the royalty-on-royalty must also be excluded to limit the royalty to 12 1/2 percent of value, as required by Federal Coal Leasing Amendments Act (FCLAA).

A cure for part of this problem would be adoption of the industry proposal to use the same point used by I.R.S. to measure depletion as a measure of "value, for coal royalties. Use of the I.R.S. point will create more certainty in valuation, and will assure that the royalty is assessed only upon the value of the produced coal itself and not upon taxes, transportation, beneficiation, and other costs which are not part of the intrinsic value of the produced coal. The MMS regulations should also be conformed to existing I.R.S. regulations and definitions to assure consistent treatment of "arms-length" contracts.

If MMS decides to adopt its proposed "gross proceeds" method of valuation, rather than using the I.R.S. depletion point, all fees and taxes (including severance taxes), transportation, beneficiation, and take-or-pay payments, and royalty-on-royalty should be excluded from the valuation. Take-or-pay or similar payments, where no coal is actually produced and sold, should not be subject to royalty assessment as proposed by MMS. Take-or-pay payments and the like do not represent a payment for the coal itself, but is instead of payment to the coal miner to assure a measure of protection from the burden of fixed costs in the event of a loss of production. The coal itself remains in the ground, and should be subject to a royalty only when extracted and sold.

The rising royalty costs for federal coal resulting from the MMS proposal will likely force some users to turn to state or private coal with a lower royalty rate or to less expensive federal coal. In either case, this will result in a loss of royalties flowing into state and federal treasuries.

We helped make possible the development of federal coal and the royalty income that has resulted when rural electric generation and transmission system, including Colorado-Ute, entered into long-term coal contracts for federal coal. We invested billions of dollars, much of which REA financed, for the electric generating plants that burn federal coal. These decisions were made with the expectation of continued reasonableness in the federal royalty program.

The joint coal and electric industry proposal to MMS by NRECA and others is reasonable and should be adopted. We respectfully request your help in designing a reasonable federal coal policy. NRECA's resolution regarding federal coal policy is attached. (See Exhibit "B").

Thank you for this opportunity to address this Subcommittee.

[redacted]

JUL 1987
RECEIVED

July 21, 1987

Mr. Dennis C. Whitcomb, Chief
Rules and Procedures Branch
Minerals Management Service
Building 85, Denver Federal Center
Post Office Box 25165, MS 651
Denver, Colorado 80225

RE: REVISION OF COAL PRODUCT VALUATION REGULATIONS
RELATED TOPICS, 43 CFR Part 3480

Dear Mr. Whitcomb:

On behalf of the industries that have been developing an alternative approach to coal product valuation, it is our pleasure to submit the attached alternative proposal to the Minerals Management Service (MMS) for consideration.

The industry alternative is based on rules proposed by MMS on January 15, 1987, at 52 FR 1840 and represents a significant revision of that proposal. Deletions are indicated with brackets and additions are underscored. Detailed justifications accompany each revision. We have attached an executive summary and a comparison chart of various points in the valuation process.

We believe that the approach embodied herein, utilizing the Internal Revenue Service Code for depletion calculations, results in a reasonable and time-tested alternative to the "gross proceeds" methodology advanced by MMS in January of this year.

Our preliminary calculations indicate that this methodology is fair to consumers and should not result in the artificial market impacts that are likely under the MMS proposal. It merits a careful review.

Sincerely yours,

William McCollam, Jr.
WILLIAM MCCOLLAM, JR.
President
Edison Electric Institute

Richard L. Lawson
RICHARD L. LAWSON
President
National Coal Association

Lawrence S. Hobart
LAWRENCE S. HOBART
Executive Director
American Public Power Association

John A. Knebel
JOHN A. KNEBEL
President
American Mining Congress

Bob Bergland
BOB BERGLAND
Executive Vice President
& General Manager
National Rural Electric
Cooperative Association

Fred Palmer
FREDERICK D. PALMER
General Manager
Western Fuels
Association, Inc.

EXHIBIT "A"

EXECUTIVE SUMMARY

COAL/ELECTRIC UTILITY ROYALTY VALUATION PROPOSAL

Executive Summary

Valuation Concept

Coal valuation, for federal royalty purposes, should be based upon the following concepts:

- Value for royalty purposes should be determined at a fixed, defined point in the production process immediately upon completion of crushing and sizing of coal actually mined from federal leases (Point 5 on attached chart).
- Value should be calculated starting with an established and consistent benchmark which is "gross income from the property" as determined in accordance with the provisions of Internal Revenue Code Section 613 and related regulations (Point 8 on attached chart). "Gross income from the property" includes all income generated by mining, basic processing and loading functions. Each mine operated by a coal producer is required by Internal Revenue Service to calculate "gross income from the property" on a mine specific basis to claim statutory depletion.
- Value should exclude all processes and handling beyond the defined point of valuation.
- Value should exclude all direct government levies such as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees, state severance and production taxes.
- To arrive at net royalty value, it would be necessary to make certain mechanical adjustments to the IRC 613 depletion base. Specifically, it would be necessary to add all non-federal royalties attributable to coal produced from federal leases, since these amounts are the only portion of the selling price excluded from the depletion base. It would also be necessary to deduct the processing allowance as well as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees and state severance taxes.

The formula for determining net royalty value in accordance with this proposal may be expressed as follows:

$$\text{Net Royalty Value} = \text{Depletable Income From the Lease} + \text{Non-Federal Royalties Attributable to the Lease} - \text{Processing Deduction} \; \& \; \text{Direct Government Levies}$$

Impact On Specific Issues

Royalty valuation at a fixed point in the production process using the IRC 613 federal depletion benchmark will produce the following results:

1. **Greatly reduce and simplify MMS administrative procedures and costs because the starting point for determining value would be a well-defined and universally available benchmark that is easily verified with a minimum of effort (Point 6 on attached chart).**
2. **Substantially reduce and simplify coal producer compliance costs in that a simple mechanical calculation would be all that is necessary to remit royalties. It would not be necessary to wade through and/or submit volumes of contractual and financial data, most of which would generate more confusion than fact.**
3. **Royalty liability, most of which is ultimately paid by electric utility consumers would be a determinable amount not subject to major, unexpected fluctuations and audit changes.**

4. Eliminate the arguments over what is and is not an arms-length contract because IRC 613 arms-length determinations are based upon the long standing, tested definitions. If these definitions work for Internal Revenue Service for federal percentage purposes, they should work equally as well for MMS and the coal industry for federal royalty purposes.

5. The calculation would be self policing in that it would be in the coal producer's best interest to maximize "gross income from the property" for depletion purposes, thus maximizing federal royalties. This would be so even though the depletion rate, now effectively 8%, is less than the current 12.5% royalty rate because, in the vast majority of cases, the royalty is reimbursed by the electric utilities while depletion accrues to the benefit of coal producers.

6. Eliminate the so-called "take-or-pay" issue because payments for under-utilized mine facilities are excluded from the depletion base by IRS, since they are not related to the ownership, mining or production of coal (Point 11 on attached chart).

7. Eliminate the offensive practice of applying federal royalty on itself because royalties are not included in the producer's depletable income (Point 10 on attached chart).

8. Eliminate the current MMS effort to impose royalty on new coal technologies and processes such as liquifaction, gasification and thermal drying. Such activities are deemed by IRS to be refining processes not related to mining or basic processing of coal and, therefore, not subject to depletion (Point 9 on attached chart).

9. Eliminate the need for an outbound transportation deduction because IRS regulations specifically prevent the inclusion of outbound transportation in depletable income. In-mine and pre-basic processing transportation is included in depletable income (Point 12 on attached chart).

10. Greatly simplify the processing deduction (washing deduction in MMS proposal) by substituting a tried and tested allocation method found in IRC 613. Use of the depletion allocation method reduces the potential for abuse and, therefore, the need for restrictive percentage limitations (Points 7 and 8 on attached chart).

11. Eliminate the compounding of royalty on federal and state taxes and fees by providing a deduction for such levies because they reduce rather than enhance the value of coal (Points 4 and 8 on attached chart).

Justification

The use of "depletable income" as the starting benchmark for determining value in tandem with a fixed physical point of valuation will greatly streamline royalty administration. The result will be more accurate and predictable valuation with fewer disputes.

Use of the proposed cost driven price allocation method of calculating the processing deduction will substantially reduce the complexity of the calculation as proposed by MMS. The result will be improved auditability, predictability and fairness. The potential for excessive deduction is greatly reduced because the method proposed in the attached comments is an allocation of price as contrasted to the MMS proposal which is to calculate the allowance independent of price using a complex and unrealistic formula.

The proposed deductions for Black Lung Excise Tax, Abandoned Mine Land Fees and state and local taxes based on production adhere to the long established ad valorem concept that cost or price only equal value when established by the action of a free market. When the cost or price of coal is increased through the direct imposition of taxes, fees and royalties by government action, value is decreased, not increased. Federal coal becomes less competitive in the market place and less desirable as an income generator from the producer's perspective.

MMS recognized the inherent unfairness of imposing federal royalty on Black Lung Excise Tax and Abandoned Mine Land Fees noting that government could increase its royalty by increasing taxes and fees. The same logic applies equally as well to state severance tax and even moreso to the imposition of royalty upon itself.

Allowing price driven taxes, fees and royalties to cross-apply, each upon all the others, causes the effective rate of each to substantially exceed original legislative intent. We strongly assert that such practices are poor public policy that will negatively impact the development and production of federal coal, in the long term. If there is economic or political justification for the imposition of, or increase in a government levy, legislative bodies should act accordingly. Allowing price driven levies to compound upon themselves, and each other, substantially increases such levies outside the legislative process. We submit that prudent public policy should be that all government-imposed taxes, fees and royalties should stand independently on their own merits and be imposed, increased or decreased without interrelated impact.

Conclusion

The MMS proposal in reality ignores basic ad valorem concepts and substitutes totally inappropriate "gross income tax" concepts. If Congress had intended to levy minimum ad valorem royalties in excess of 12.5% (8% for deep coal) or a "gross income tax" on the receipts of mining companies, it would have so indicated. Clearly, Congress did not intend such results. The intent was to levy a royalty on the value of coal actually produced from federal leases.

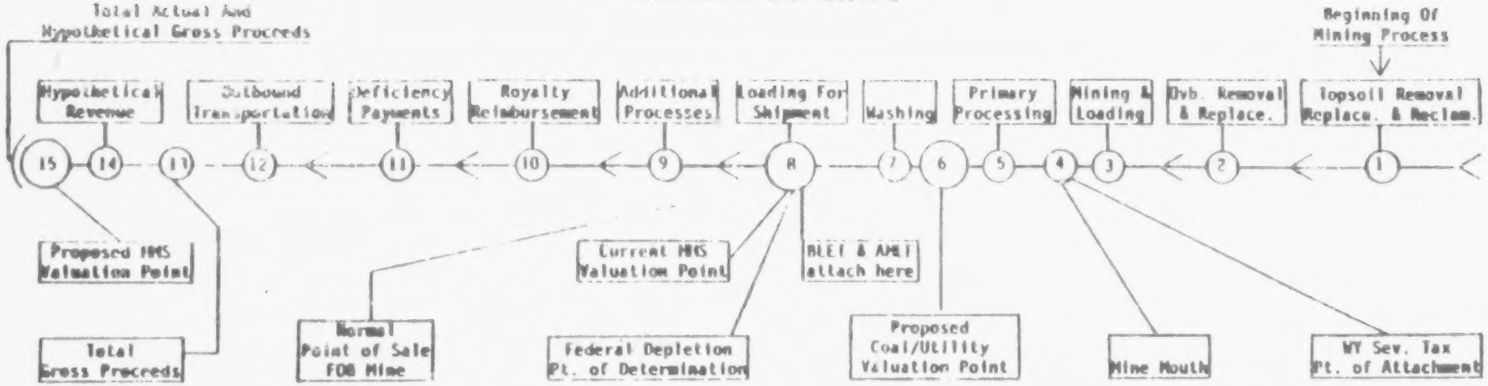
The attached flow chart visually summarizes the significant issues related to coal royalty valuation. The example mine depicted on the chart is a Wyoming, Powder River Basin, surface mine. Generally, most of the issues are common to all mines.

The advantages of the coal/utility industry proposal in terms of legislative intent, appropriate public policy, administration and fairness are exceedingly obvious. The result would be a smoothly operated royalty program which would be in everyone's best interest. We urge MMS to adopt the depletion based federal coal royalty valuation program set forth in the following comments.

7/013
attachment

FEDERAL ROYALTY VALUATION COMPARISON

Wyoming Surface Mine Example


Total Actual And Hypothetical Gross Proceeds
Beginning Of Mining Process
Hypothetical Revenue
Outbound Transportation
Deficiency Payments
Royalty Reimbursement
Additional Processes
Loading For Shipment
Washing
Primary Processing
Mining & Loading
Ovb. Removal & Replace.
Topsoil Removal Replace. & Reclam.
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
Proposed MMS Valuation Point
Total Gross Proceeds
Normal Point of Sale FOB Mine
Current MMS Valuation Point
Federal Depletion Pt. of Determination
BLET & AMLF attach here
Proposed Coal/Utility Valuation Point
Mine Mouth
WY Sev. Tax Pt. of Attachment

(1)(2)(3) Basic surface mining functions -- comparable functions occur in a deep mine.

(4) Point at which coal reaches surface or level grade. Wyoming severance tax liability is determined at this point.

(5) Crushing and sizing

(6) Coal industry believes royalty should attach and value be determined at a defined point at which coal achieves marketable condition (after primary processing).

(7) Traditional coal washing (seldom done in Powder River Basin).

(8) Federal depletable income is determined at this point. Gross proceeds related to any process, function or activity occurring after this point is non-mining and not subject to statutory depletion. Black Lung Excise and Abandoned Mine fee attached at this point. Existing MMS regulations determine value at this point.

(9) Additional processes (liquifaction, gasification, thermal drying) using marketable coal as feedstock.

(10) Federal royalty reimbursement included in coal purchased under long-term coal supply agreements.

(11) Payments for under-utilization of mine facilities when purchaser is unable to accept coal.

(12) Outbound transportation may be included in price when quoted on a delivered basis.

(13) Total receipts for functions and activities to this point equal total actual mining and non-mining income received by coal producer.

(14) MMS proposes to add to actual gross proceeds any amount they determine could have been charged the purchaser without regard to actual market results.

(15) MMS proposed valuation point includes both real and hypothetical revenue, reduced by: partial deductions for outbound transportation; additional processes and washing; full deductions for Black Lung Excise Tax and Abandoned Mine Land Fees.

NRECA RESOLUTION

Federal Coal Royalties

Currently, federal law requires that a royalty of 12 1/2% of total selling price be paid on surface-mined coal from federal lands. This percentage royalty is paid irrespective of heat content, location or quality.

In most cases this royalty is higher than royalties paid to private holders of coal reserves. This high royalty will cause mining companies to bypass these federal reserves for economic reasons. Once bypassed, it is highly unlikely that this coal will ever be mined, thus wasting a natural resource. This practice will be particularly true in lignite mines which are already marginally competitive.

We urge Congress to amend present federal law to permit the royalty rates on federal coal to be negotiated, thus avoiding the bypassing of these federal reserves.

EXHIBIT "B"

Senator CONRAD. Thank you very much.

Let me explore this question of whether taxes or royalties ought to be included in the base value of coal. In a private royalty contract, private royalty owner, are State and local taxes included in the calculation of value?

Mr. PETERSON. Of the private leases that we know of, no, because at least to date they are established of a fixed price.

Senator CONRAD. On the basis of fixed pricing.

Mr. PETERSON. So much per ton of coal.

Senator CONRAD. And so, if you have a State severance tax or a local county tax, that does not get included in the base valuation.

Mr. PETERSON. The ones we have dealt with, yes. I don't know that that is true in the industry.

Mr. COOVERT. Senator, we have done some extensive analysis of private ad valorem leases to see what the norm is. And the norm is that taxes, fees and government royalties are removed from the price to arrive at the royalty base.

Senator CONRAD. And what is the rationale of MMS, as you have been able to divine it, for including taxes in value?

Mr. COOVERT. Again, I think it goes back to the comparison with gas and oil and the assumption if gross proceeds, which includes everything in theory, is used as the basis, we are being treated equally. The problem is that when you look at that gas and oil, in the private sector gas and oil royalties are typically one-eighth, or 12½ percent. If that's not universal, it's extremely prevalent. If you look at coal—and by the way, that one-eighth is of gross proceeds. If you look at coal, that's not the case. It is 4 to 5 percent maybe. And it is of net proceeds. There is just a whale of a difference.

Senator CONRAD. And have you been able in your review to analyze how those differences developed? I presume they were market-driven differences, the difference between a one-eighth royalty, a royalty that is off of gross, and one that is 4 or 5 percent off a net.

Mr. COOVERT. Right. They have evolved over a long period of time. Years ago in the coal business the typical royalty was cents per ton like the old Federal royalty was. When the market balance changed in the early 1970s, that changed. And there was a rather rapid evolution to price-driven royalties, but at the same time these taxes and fees were removed. And the reason they were removed is because it is value. Ad valorem in its purest sense is intended to mean value at a fixed point. And if that is the case, then increasing the price of a given product, coal in this particular case, by adding a tax or a fee or a royalty does not necessarily increase its value. In fact, I think you can make a case for the contrary.

Our position is really very simple. All of these government taxes, fees and royalties, if there is legitimate reason for them being imposed, then so be it. But we don't believe any of them should feed each upon the other and cross-compound. And looking at this royalty is just one aspect of that.

We have all of these—anything that is price-driven is going to be compounding each upon the other because of the nature of the way we sell our coal. Our coal is sold under escalating contract generally speaking. So, that cost winds up in the customer's utility bill; whereas, gas and oil is sold generally speaking based upon the world price. And if Congress in its wisdom increases a fee on tax and oil or a tax today, tomorrow's price is not going to necessarily reflect that because the world price controls. That is not the case in coal. It is very different.

Senator CONRAD. In other words, the price of oil has a cap on it with relationship to the market. The cap is determined by that world market price and whatever is going to be a royalty is going to come out of somebody's pocket who is in the stream. It is not going to be an add-on, which is the case with coal.

Mr. COOVERT. Yes. That's generally true. I wouldn't exactly characterize it as a cap because it can rise and fall rather rapidly as history has demonstrated.

Senator CONRAD. But in relationship to—I'm talking about the world market price itself provides a cap.

Mr. COOVERT. Yes, yes, it does.

Senator CONRAD. So, if there is added tax or an added fee or an added royalty somewhere in the stream, it has to come out of the world market price.

Mr. COOVERT. That is correct. And it does not compound upon itself, or they do not compound upon each other because of that mechanism.

Senator CONRAD. I was a State tax commissioner for 6 years and an assistant State tax commissioner for 6 years before that. And trying to get people to understand that fundamental difference is not always easy.

Mr. COOVERT. No.

Senator CONRAD. But it is a very basic difference.

Senator Nickles.

Senator NICKLES. Senator Conrad, thank you very much.

It has been an enlightening process listening to the witnesses because of the differences and, I might say, the inequities between taxation on various minerals. I am interested in the issue. And I would say I am sympathetic to many of the statements that have been made where you didn't want the taxes to be compounding on each other.

Some States—am I correct—I don't know if it is Wyoming or Montana. Do they have a 30 percent excise tax on coal?

Mr. WHITE. Senator, Montana has historically had a 30 percent severance tax. In the 1987 legislative session, legislation was passed that will ramp that down to 15 percent.

Senator NICKLES. Is that on net proceeds or gross proceeds?

Mr. WHITE. Let's see. That's on a gross proceeds basis, yes.

Senator NICKLES. That's on a gross proceeds basis?

Mr. WHITE. That's right. I'm sorry. The production tax itself is removed in the calculation. So, it is on a net of the production tax proceeds.

Senator NICKLES. I didn't quite follow you.

Mr. WHITE. The severance tax——

Mr. PETERSON. It is closer to net than it is to gross, sir.

Mr. WHITE. Yes, it's not either because the formula takes out the production tax itself in the calculation of the severance tax.

Senator NICKLES. I see. It doesn't place the 30 percent on itself.

Mr. WHITE. That's correct.

Mr. PETERSON. That's correct.

Senator NICKLES. It is interesting. It is interesting how they have done it, and again, I concur with your statement that you wouldn't want to have taxes on taxes. However, we do in the oil and gas industry. We have the royalties based on gross proceeds regardless of what the severance taxes are. Then we come back on the oil and gas industry, you have a windfall profits tax on top of that. So, you have a Federal excise tax. You have the State excise tax. You have the royalties. So, you really have a situation that is, I'm going to say, very inequitable or very different from taxation in coal.

Now, is your statement such that you think that coal royalties should be just based on a Federal mandated minimum cents per ton basis without regard to price?

Mr. COOVERT. No, Senator, that's not our proposal. Our proposal is modified version of a price-driven valuation, ad valorem process whereby you would take the arm's length selling price of produced coal, FOB mined, and back out the government imposed direct levies, including taxes, royalties and fees.

Senator NICKLES. So, it would be a percentage of net proceeds?

Mr. COOVERT. Yes, it would be.

Senator NICKLES. What percentage?

Mr. COOVERT. We haven't even gotten into that. The statute requires that the percentage presently be 12½ percent of value for surface and 8 percent for deep coal. And in this proposal we are addressing the valuation issues, not the rate.

Senator NICKLES. So, the industry would be flexible on the rate if it was on net proceeds? Is it present law that says it will be a minimum of 12½ percent on gross proceeds, or is that a proposed regulation?

Mr. COOVERT. It is on value. And the dispute is over how you determine value.

Senator NICKLES. I understand. Is there a dispute—as I was reading through your statement and a couple of others over the 12½ percent as well?

Mr. WHITE. That's correct. Senator, the 12½ percent is approximately three times what we could determine the average for private coal leaseholders throughout the United States would be. So, you are increasing the market price of Federal coal almost three times over what private coal would be. And we don't think that is realistic.

Senator NICKLES. Do you think, if that was to happen, that you would just produce little or no Federal coal? Or would you see an escalation of private royalties to the Federal level?

Mr. WHITE. I think both could occur. If you leave the royalty at the 12½ percent, obviously the private leaseholders are going to attempt to gain more for their coal.

But as I said earlier, at our mine right now we have a team of engineers that do nothing but try and design mine plans so we can avoid Federal coal. And next year we are going to be successful in that 73 percent of our coal will come from non-Federal leases even though about half of our coal that we have under lease is Federal coal.

So, I think you're going to see both occurring. But mining companies are going to try and keep the product in the market. It is a very tight market, and so they're going to go with the lowest cost royalty coal.

Senator NICKLES. Now, you mentioned that presently your company is trying to minimize its production of Federal coal. But aren't Federal coal royalties now competitive to private royalties?

Mr. WHITE. We are one of the first companies where our leases have begun to roll over and we are in to this 12½ percent royalty coal.

Senator NICKLES. So, any new production that you have or some of your production on Federal production is now rolling into the 12½ percent?

Mr. WHITE. That's correct.

Senator NICKLES. And your average coal royalties in the private sector are 4 percent, 5 percent?

Mr. WHITE. Well, I think it is a little less than that actually now. We are running at 17½ cents.

Senator CONRAD. Would the Senator yield on that question?

Senator NICKLES. Sure, sure.

Senator CONRAD. When we are talking about an average of 4 percent, 5 percent, whatever it is, on the private sector, are we talking about the most recent contracts, or are we talking about some very long-lived contracts that are out there?

Mr. WHITE. Senator, in our instance, these contracts are long-lived contracts that will begin to roll over in 2 to 4 years.

Senator CONRAD. Is there any analysis on—I presume there is—what is going to happen to those in terms of the relationship between the private royalty owner and purchasers in terms of what is likely to happen at the end of that two years? Or is there an analysis that looks at more recent contracts that have been entered into with private royalty owners and what that differential might be?

Mr. WHITE. Well, in answer to the first question, if we look at what we anticipate, I am sure that the private leaseholders in our instance are going to attempt to push the royalty rate up towards the 12½ percent.

However, we have a substantial mine in Texas, and we have I think 365 leaseholders down there. And the rate that we have down there which is quite recent—it has been entered into since 1976 and on up until some of them have been entered into very recently. And the rate that we are paying there is at least half or less than half of the proposed Federal royalty rate.

Senator CONRAD. So, higher than the average that you would get from looking at all contracts that are out there that would include longer life contracts, but still substantially less than what you would get with the Federal royalty.

Mr. WHITE. I think that is a fair statement, yes.

Senator CONRAD. All right. Thank you.

Senator NICKLES. Thank you, Mr. Chairman.

To kind of follow up on our previous discussion, Mr. White, are you objecting to the 12½ percent, or is it more just a question of whether or not the 12½ percent would be on gross or on net?

Mr. WHITE. I think we are objecting to the formula for calculating the Federal royalty. But we are also stating that we feel the Federal Government is pricing its coal well above the market and is not going to be able to sell its coal if it continues that practice. And we object to that, yes.

Senator NICKLES. What percentage of coal in the United States is produced from Federal lands?

Mr. WHITE. I think we have a statistic here that says out of 800 million plus tons that were produced in 1986, 163 million, if I'm remembering correctly, were produced from Federal leases.

Senator NICKLES. About 20 percent or something?

Mr. WHITE. Something like that, yes.

Senator NICKLES. And you think that would diminish as the years go by and more and more leases are rolled over into the 12½ percent?

Mr. WHITE. Yes.

Senator NICKLES. Has production from Federal lands decreased in the last few years?

Mr. WHITE. I'm not sure if I can answer that. It increased as we began to develop some of the low sulfur coals in the West, and as the price of oil was driven up through the Arab oil embargo. But I think that that market has reached some kind of an equilibrium. And although I don't have an analysis of it, I don't know if Don does.

Senator NICKLES. If you could get it or NCA, if they could get it for the record—well, we can get that from the Department. I'll ask that question of Mr. Griles.

Back to the industry's request. It is not the industry's request to have a flat, fixed cents per ton basis. Am I correct on that? You've evolved where you are agreeable to a percentage of net proceeds, that percentage being undefined at the present time.

Mr. COOVERT. I think that's the consensus of opinion, yes.

Mr. WHITE. Yes, I think that is correct.

Senator NICKLES. Well, I was going to say. A cents per ton would seem to be not to be very adequate since you have different Btu levels and all types of different qualities and high sulfur, low sulfur, et cetera. A cents per ton would seem to be more archaic or less accurate or less definable of the value of the resource. It seems like it should be—and at least as far as this Senator is concerned, I'm not an expert in coal, but that it should be some type of percentage of value. And I would agree that you certainly don't want to get into a situation of paying royalty tax on black lung benefit taxation and others.

The question of paying it on State severance taxes is interesting because then you get into a question of priority. You know, should you have State severance taxes on Federal royalties or Federal royalties—who should be minusing who. And one could easily argue it should be the other way around. It should be your State severance taxes, which I believe you said like in Montana's case is one gross—it's something in between. I don't want to use that valuation. I guess the Montana tax would be on a value that would—and that 30 percent tax would be including a tax on the Federal royalty. Is that accurate?

Mr. PETERSON. No.

Senator NICKLES. That is not the case?

Mr. PETERSON. It is subtracted out. The 17½ cents is in there, the fixed royalty. The percentage royalty is not; it has been subtracted out.

Senator NICKLES. So, the State does not get a 30 percent tax on the Federal royalty.

Mr. PETERSON. The percentage royalty, no, they do not.

Senator NICKLES. But they do on the fixed?

Mr. PETERSON. On the 17½ cents, yes.

Senator NICKLES. Is that right?

Mr. PETERSON. Yes.

Senator NICKLES. This is really a quagmire that you have in your little industry.

Well, I wish you well. I hope that some things can be—Mr. Chairman, I look forward to Mr. Griles' testimony as well. And I thank our witnesses.

Also, I appreciate the statement, Mr. White, that you made concerning the private royalties as an average would come out to what? Around 4 percent of net, something like that?

Mr. WHITE. That's correct.

Senator NICKLES. In that area.

Mr. WHITE. Before you conclude—I sense you are going to conclude here—let me suggest that one of the concerns that has been expressed is whether there is an accurate analysis of the impact comparing the MMS proposal to our proposal. And the industry has made a real effort to try and quantify that impact. And we would like to submit for the record this book which we think is a good shot at that.

Senator NICKLES. On that line, I might just ask for a statement as far as the differences in total amount of revenues that would be anticipated under the MMS proposal and the Coal Association's proposal. Do you have that?

Mr. WHITE. We have made an estimate. And what we have come up with is the actual in 1986 that was collected was $108 million. Using a 1990 projection, the MMS proposal suggests that there would be $173 million. And our proposal suggests there would be $134.7 million collected.

Senator NICKLES. By the year 1990?

Mr. WHITE. That would be the 1990 projection, yes.

Senator NICKLES. Thank you very much.

Senator CONRAD. Thank you. Before you leave, one other question that I would like to address to this panel.

I received a letter from my governor that says—and I just want to quote a couple of lines from it and get your reaction. "The combination of long-term cost plus contracts with the Federal royalty valuation methodology has resulted in royalties on North Dakota lignite being double or even triple the royalty paid on much of the coal sold in other western States even though North Dakota lignite has a much lower intrinsic value."

Obviously, the differences are you are in a mine mouth operation. The cost of mining is higher in North Dakota. That is reflected in the contracts. The overall relationship is acceptable because of the transportation savings because you are operating in a mine mouth environment. But nonetheless, the way the Federal royalty is calculated results in our industry paying a Federal royalty that is often two or three times higher than what you get in other western States even though lignite is of much lower quality.

Is there anything in your proposal that addresses that unfairness, that underlying problem?

Mr. COOVERT. To a degree, yes. And "to a degree," I mean the elimination of the government taxes and fees tends to move back in the other direction toward a range of equality. There will still be a difference on a delivered heat content basis because, of course, as you pointed out, these are generally mine mouth operations. But the movement under our proposal would be back in the other direction. So, the range of disparity would not be that great.

Senator CONRAD. All right. We want to thank this panel. We also want to tell you that members of the subcommittee may have more questions, and we will keep the record open for that purpose. Those questions may be submitted to you in writing.

Next we will hear from Steven Griles, the Assistant Secretary for Land and Minerals Management, the Department of the Interior. We are altering the hearing schedule because Senator Nickles would very much like to hear from Mr. Griles, and Senator Nickles' schedule requires him to be elsewhere momentarily. So, we are going to make this alteration in the schedule of our witnesses so we can accommodate Senator Nickles' schedule.

Senator NICKLES. Mr. Chairman, thank you very much. I appreciate the accommodation.

STATEMENT OF J. STEVEN GRILES, ASSISTANT SECRETARY FOR LAND AND MINERALS MANAGEMENT, DEPARTMENT OF THE INTERIOR

Mr. GRILES. Mr. Chairman, in view of the time, let me submit for the record the full text of my testimony, try to just elaborate on a couple of key issues, and then respond to the questions that legitimately are being raised by the panel before me and by the panel after me and by you also.

First, Mr. Chairman, today we published a notice of proposed rulemaking on our proposal in order to take into account and allow us to include these matters before the committee within our deliberations.

Mr. Chairman, I think the witnesses before you pointed out that in 1976 Congress directed that all future coal leases and royalties from Federal coal leases would be based on the value of production and not on cents per ton, and all pre-1976 leases were to reflect that value projection when those leases were readjusted. I believe this requirement is one of the key features that is causing much of the consternation and controversy, as evidenced by Mr. Martin's testimony.

This is not a new issue. In 1984 the Linowes Commission, which was appointed to study the coal leasing program, talked about that issue. They recommended: "The base for calculating Federal royalty payments should be on the FOB price minus all State and local severance taxes and similar taxes." Secretary Clark at that time responded to this recommendation and concluded with the belief that "this issue must be addressed by Congress after a study of its effects on other programs and on State and local governments." So, we were not unaware in 1984 that this was a controversy that needed to be dealt with.

Mr. Chairman, the current status of these coal leases is as follows: there are 552 coal leases. Of these 552, only 125 are producing. Of that 125, 98 have been adjusted: that is, they now have the 12½ percent royalty rate in effect on them. So, 78.4 percent of the leases that are producing have been adjusted.

However, they only account for 56.2 percent of the coal produced on Federal leases in 1986. By November of 1989, this production percentage is expected to increase to 80.5 percent because 12 more leases of the 125 that are producing will have been readjusted.

As you can see, the amount of royalty to be paid in the future will greatly increase once the remainder of the pre-1976 leases are adjusted and begin to produce. So, this isn't a small dollar amount. It is of tremendous impact on both the coal industry, as well as the revenues that are paid to the Federal Government and to the States, localities and et cetera.

Now, we have been spending a great deal of time, Mr. Chairman, over the last year looking at this program. When I say "this program," I mean royalties in generic terms, oil and gas as well as coal. Oil and gas and coal were proposed as regulations last year. And the Secretary did that after appointing a royalty advisory committee that set forth and had various panels—one on coal, one on oil, and one on gas—in order to try to come to some consensus about what these regulations should be. We have had numerous comments. And I have to admit there is no consensus to be had on this subject whether it be oil, gas or coal.

What we are trying to do, Mr. Chairman, is to figure out what is in the best interest of all parties, and that includes States, the Federal Government, the producers, as well as others who are affected.

We had a meeting with the Western States Governors' representatives in late September. And after that, I got a letter from Governor Schwinden of Montana representing the views of all of the governors. But after that, I got letters from Governor Sinner, Governor Romer, Governor Sullivan, all differing with the consensus viewpoint. [Laughter.]

Senator **Nickles**. Kind of like Congress.

Senator **Conrad**. Like the Senate.

Mr. **Griles**. I would like to submit those for the record if I could, Mr. Chairman, because I believe it is important that the record reflect that there is no consensus even among elected officials out there as to exactly how we should best value the product, what deductions should be allowed and what the "take," if you will, should be for the government.

Senator **Conrad**. Couldn't we just take Governor Sinner's position? [Laughter.]

Mr. **Griles**. Governor Sinner is a very effective advocate. I admire his tenacity as well as his ability in dealing with these issues. His words will not go unnoticed.

I would like to address what I think is really the issue surrounding the debates, and that is, as has been pointed out, what is the proper basis for the valuation of coal.

Essentially the issue is how much coal producers will be expected to pay and the magnitude of payment relative to historical obligations. As you know, many existing coal leases include the royalty obligations on a cents per ton basis. As I indicated, a little less than 50 percent of the Federal coal produced today is still based on royalties of 15 to 25 cents a ton. Those leases will be readjusted mostly by 1990, 1991.

Changing to an ad valorem approach has resulted in producer royalty obligations increasing by 5 to 10 percent. Correspondingly, that is a 500 to 1000 percent increase in royalties by going to an ad valorem basis. And that was mandated by the 1976 Coal Leasing Amendments Act. That Act says: "A lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12½ per centum of the value of coal as defined by the regulations, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations."

[The prepared statement of Mr. Griles follows:]

OPENING STATEMENT OF J. STEVEN GRILES
ASSISTANT SECRETARY - LAND AND MINERALS MANAGEMENT
U.S. DEPARTMENT OF THE INTERIOR

Before the
Senate Energy and Natural Resources Committee
Subcommittee on Mineral Resources Development and Production
November 16, 1987

I want to thank the Chairman and Members of the Subcommittee for the opportunity to appear today to discuss proposed rulemaking of the Department of the Interior (DOI) affecting valuation, for royalty purposes, of coal produced from Federal and Indian lands. In order to accommodate the scheduling of this hearing, the Department of the Interior is publishing in the Federal Register a Notice of Intent to Issue a Further Notice of Proposed Rulemaking, which will allow us to include matters raised in these proceedings as part of the official rulemaking record.

In my remarks, I want to detail a little of the background that has brought us here today, and discuss what I believe to be the basic issue of coal product valuation.

The DOI has, as one of its major responsibilities, the collection and disbursement of oil, gas, coal and other mineral receipts from leases on Federal and Indian lands. The majority of these mineral revenues are in the form of production royalties paid to DOI. In the case of coal leases, royalty is calculated either on a cents-per-ton basis or on a percentage of the value of production.

In 1976, Congress directed that all future royalties from Federal coal leases would be based on value of production and not cents per ton and that all pre-1976 existing leases were to reflect value of production when those leases were readjusted. Mr. Chairman, I believe it is this requirement that is one of the key issues in this debate.

This is not a new issue. In 1984, the Commission on Fair Market Value Policy for Federal Coal Leasing addressed the issue of what constituted an appropriate royalty basis. They recommended: "The base for calculating Federal royalty payments should be the F.O.B. price minus all State and local severance and similar taxes." (Recommendation VII-5). Secretary Clark in his response to this recommendation concluded with the belief that "this issue must be addressed by Congress after a study of its effects on other programs and on State and local governments." (page 39). The Secretary noted that to subtract reimbursements for State and local severance taxes would result in inconsistent treatment with oil and gas and other minerals.

The current status of the lease readjustment is as follows: There are 552 Federal coal leases of which 125 are producing. Of these 125 producing leases, 98, or 78.4 percent, have had their royalty rates readjusted. These account for 56.2 percent of the coal produced on Federal leases. By November, 1989, this production percentage is expected to increase to 80.5 percent because 12 more leases of the 125 producing leases will have their royalty rates readjusted.

As one can see, the amount of royalty to be paid in the future will greatly increase once the remainder of the pre-1976 leases are readjusted and begin to produce coal.

The Department is currently in the rulemaking process to amend product value regulations for coal and oil and gas leases. At the outset, I believe it is important to acknowledge the special effort made by all affected parties during recent months in the development of our oil and gas regulations. After a series of meetings, both in Denver and here in Washington, with representatives of Congress (including staff members from this committee), States, Industry and Indian lessors, the Department was able to craft what we believe to be a near consensus over the form and substance of our proposed rules.

This process was very successful, not only because we were able to develop new proposed guidelines for oil and gas, but because all affected parties learned a great deal about the problems and concerns of the others and the difficulties the Department faces in assessing accurate product values for oil and gas. Because of the success of this effort, the Department will attempt to follow a similar process for the ongoing development of our new coal product value guidelines.

The process of amending the product value guidelines was initiated in response to recommendations contained in the January 1982 Linowes Commission Report. Coal rules were subsequently developed as a part of a larger project to improve the principal product value rules for royalty management. An advance Notice of Proposed Rulemaking was issued for public comment in January 1986. During this period, the Secretary established a Royalty Management Advisory Committee (RMAC), composed of representatives from States, Indian Tribes and allottees, and from the coal, oil and gas industries, to advise him on royalty management issues, including appropriate changes to DOI regulations regarding product value for royalty purposes. This group first met in January of 1986.

At that time, the Secretary agreed to a request by RMAC to delay promulgation of proposed valuation regulations until they could review the issues and make recommendations. DOI provided copies of the draft regulations to the RMAC and the public. DOI received written comments on the draft rules from the public and held a public meeting in Lakewood, Colorado, in March 1986.

The RMAC formed three working panels to review the draft coal, oil, and gas rules, as well as the transportation and processing rules related to each product. Each of the three working panels prepared a detailed set of recommendations to the full Committee, and these were reviewed at public meetings held in July and October 1986.

The RMAC approved, for submission to the Secretary, a set of recommendations regarding certain noncontroversial provisions contained in the draft coal valuation regulations. These recommendations were substantially included in the preparation of the proposed coal valuation regulations that were published in the Federal Register in January of 1987. The RMAC did not make recommendations on the more contentious issues.

Written comments on the coal valuation regulations proposed in January were received at DOI by April 15, 1987. The number and origin of comments received by DOI on coal are as follows:

Industry and related organizations	53
State and local governments	11
Indian lessors and organizations	6
Federal Government Agencies	1
Total	71

Also during this comment period, DOI held a public hearing in Denver, Colorado, to receive further input on the proposed coal regulations from interested parties.

On July 9, 1987, the DOI reopened the coal comment period for 14 days. During this second comment period, DOI received additional significant comments from principal interested parties raising issues that merited further consideration and response from the public. To allow for this further consideration, DOI, once again, reopened the comment period on August 12, 1987, for 60 days to give interested persons an opportunity to obtain from DOI copies of three specific comments received from industry, State, and Indian representatives and then to provide a response for DOI to consider in developing a final rulemaking.

The industry comments were submitted as a joint proposal by six groups representing the coal producers and electric utilities. This proposal included a comprehensive, section-by-section set of revisions to the January proposed rulemaking, including a justification for the suggested modifications. The most significant revision suggested in the joint industry proposal was to remove the valuation standards contained in the proposed rules and substitute instead the concepts of "gross royalty value" and "net royalty value." Essentially, the industry would base royalty values on the Internal Revenue Code's concept of "gross income from property" used for depletion allowance calculations. This "gross royalty value" would be increased by amounts for non-Federal royalties and reduced by processing allowances and amounts based on Federal Black Lung excise taxes, Abandoned Mine Land fees, and State and local taxes (such as severance taxes). The resulting figure would be the "net royalty value" upon which royalties would be paid.

To evaluate the industry valuation approach, the DOI solicited interested persons to review the entire industry proposal and provide responses. The Department has received considerable comment on this proposal from the Governors of western coal producing States. I met with representatives of those Governors in Denver on September 28, 1987 to discuss their concerns with the proposals published in the Federal Register and to provide revenue information requested by the Governors.

After that meeting, I received a letter from Governor Schwinden of Montana representing his views and those of the Governors of Colorado, New Mexico and Wyoming. In summary, their comments generally supported continued reliance on the proposed valuation procedures. The Governors did not support exclusion of reimbursements for either Black Lung taxes or Abandoned Mine fees as proposed by DOI, or tying Federal royalty valuation to the Internal Revenue Code as proposed by industry groups.

In addition to that joint letter, several Governors have individually written to express where their personal opinions differ from that of the consensus view. Governor Sullivan of Wyoming and Governor Romer of Colorado indicated they could support exclusion of royalty reimbursements from gross proceeds to address the "royalty on royalty" issue. Governor Sinner of North Dakota urged the Department to continue the ongoing review of product valuation and expressed specific concerns regarding the production of lignite in his State.

The 60-day formal comment period closed on October 13, 1987. The DOI is now in the process of evaluating all written comments in its development of a Further Notice of Proposed Rulemaking.

Now I would like to address what I believe to be the real issue surrounding the debate over the proper basis for the valuation of coal for royalty purposes. Essentially, the issue is how much coal producers will be expected to pay and the magnitude of payment relative to historical obligations. As you may know, many coal leases included royalty obligations on a cents per ton basis, most often in the range of 15 to 25 cents per ton. Changing to an ad valorem approach has resulted in producer royalty obligations as much as 5 to 10 times greater than the producer originally anticipated when signing the Federal lease. Therefore, it is understandable why there is such controversy surrounding any process which involves further delineation of the producers' royalty obligation.

Mr. Chairman, as I previously stated, the 1976 Federal Coal Leasing Amendment Act provides: "A [coal] lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12.5 per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations." On its surface, royalty calculation is really quite simple: Royalty base X Royalty percentage = Royalty Obligation. However, in practice, it is much more complicated.

Since the royalty percentage for surface mining is defined by statute at 12.5%, coal producers have focused their efforts on the royalty base portion of the formula. Obviously, for the producer, a reduction in the royalty base will result in a lower royalty obligation and a smaller negative impact associated with complying with the new statutory requirement. Comments on the proposed rulemaking and the industry proposal have indicated two principal questions involving the royalty base.

- What deductions from gross proceeds will be allowed prior to calculating royalty obligations, and,

- What approach will be used to view the relationship between net proceeds (gross proceeds after allowable deductions) and the royalty obligation?

Historically, DOI has allowed few deductions from gross proceeds. In its proposed rulemaking, DOI sought public comment on the appropriateness of allowing deductions for reimbursements for Abandoned Mine Land and Black Lung fees. Industry would prefer to have additional items deducted including reimbursements for State severance taxes, amounts for beneficiation (or processing costs as industry defines it) and royalty payments. Each deduction allowed in the final coal product valuation regulations will have a direct impact on State and Federal royalty receipts.

In the past, DOI has instructed industry to pay royalty based on 12.5 percent of gross proceeds. This practice has raised the issues of royalty on royalty and royalty on taxes, in which the government share is greater than one-eighth of the lessee share. Industry has offered some alternatives which would establish different relationships between the royalty and operator portions of gross proceeds. For example, one could argue that the royalty portion of gross proceeds should be 12.5 percent and the operator is entitled to the other 87.5 percent One could also agree that the lessor is only entitled to one-eighth of the 87.5 percent. Other positions are also possible.

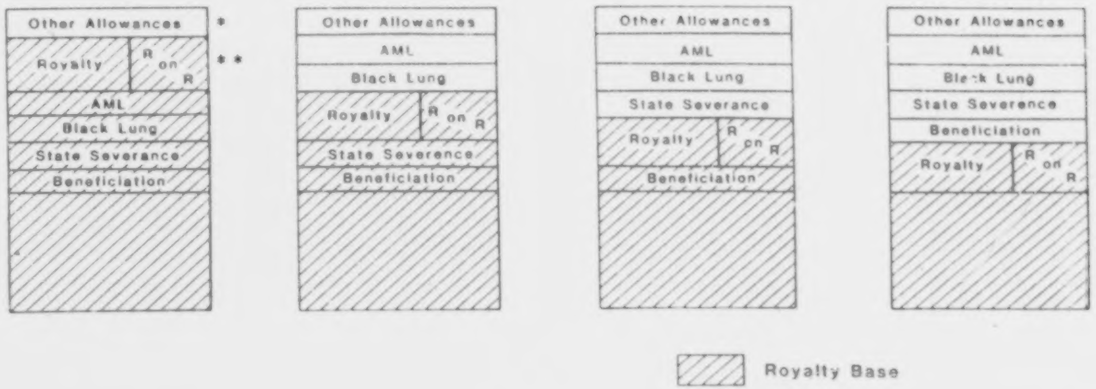
For the purposes of illustration, I will submit for the record charts which depict the concepts I have referred to above. The bottom line regarding coal product value rulemaking will be: How much should industry pay as their fair royalty obligation? The combined effect of factors described above will result in a base used for royalty obligations. This is greater than that which would be expected under the cents per ton basis, even if we choose the option designed to produce the least revenue. From a Federal Treasury perspective, any compromise from current practices must be made being mindful of impacts associated with lower royalty receipts.

In acknowledging these competing interests, it is important that all of the persons impacted by this decision be apprised of the issue and the ramifications of any regulatory decisions. I am pleased to have had the opportunity to discuss this matter with this Committee and hope we will be able to reach a common understanding of the issue. There is a significant amount of analysis to be done to determine the nature of any policy and fiscal impacts associated with the adoption of any particular position. We anticipate seeking additional public comment prior to finalizing any royalty approach.

Mr. Chairman, this completes my prepared statement. I would be pleased to answer any questions you or the Subcommittee members may have.

Optional Deductions

The deductions to gross proceeds which may materially affect the resulting net Royalty Base:


Other Allowances
*
Royalty
R on R
* *
AML
Black Lung
State Severance
Beneficiation
Other Allowances
AML
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R on R
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Black Lung
State Severance
Royalty
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Beneficiation
Other Allowances
AML
Black Lung
State Severance
Beneficiation
Royalty
R on R
Royalty Base

Obviously, many other combinations are possible. The important point is any deduction allowed prior to calculating the producer's royalty will result in lower receipts.

* Such as transportation costs that are not traditionally viewed as part of the base

* * Royalty on Royalty

How to Compute Royalty

Royalty Obligation = Royalty Base X Percentage (12 1/2 %)

Issue: What is the Royalty Base?

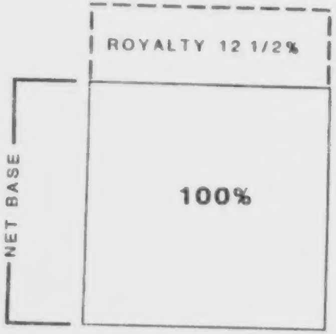
The base has two basic components:

- What deductions are to be allowed to gross proceeds prior to calculating the royalty obligation (net proceeds)?
- What approach does one take to viewing the relationship between the royalty portion and the operators portion of net gross proceeds?

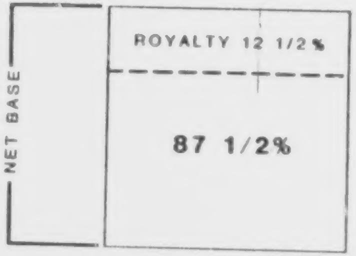
Optional Approaches

The producer's Royalty Obligation may be lowered significantly by adopting a different approach to relationship between royalty obligation and the producer's portion of the net base.

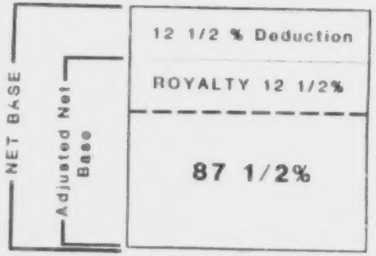
Approach A


ROYALTY 12 1/2%
100%
NET BASE

Approach B


ROYALTY 12 1/2%
87 1/2%
NET BASE

Approach C


12 1/2 % Deduction
ROYALTY 12 1/2%
87 1/2%
NET BASE
Adjusted Net Base

There has been little history for an ad valorem approach to coal. MMS has adopted the long standing approach used for oil and gas. To adopt an approach other than that will likely result in lower receipts.

Senator CONRAD. Mr. Secretary, could you just repeat what you have just said? I want to make sure that I understand the calculation that you have just made there. Could you just go over the difference that the 1976 changes require?

Mr. GRILES. Of course. Previously, before 1976, all coal leases that were let by the Federal Government had a cents-per-ton royalty lease.

Senator CONRAD. Correct. I understand that.

Mr. GRILES. That cents-per-ton base was from 15 cents to 25 cents, depending upon the type of mine, the nature of the mine, and other factors which were included.

Changing to an ad valorem approach has resulted in producer royalty obligations as much as 5 to 10 times higher than the producer originally anticipated when he signed that pre-1976 lease. So, when Congress changed the game——

Senator CONRAD. Five to ten times higher.

Mr. GRILES. Right.

Senator CONRAD. Now, obviously going to an ad valorem basis in and of itself would not require that you have that kind of increase.

Mr. GRILES. Well, the law went on and said, Mr. Chairman, that it required payment or royalty in such a manner as the Secretary shall determine, but no less than 12½ percent, which is in law.

Senator CONRAD. It is the floor.

Mr. GRILES. Yes, on the value of coal.

And so, the debate is I think as you have heard today. One is: Is 12½ percent appropriate? Is coal different? Coal is different from oil and gas——

Senator CONRAD. We have really got two central questions here. Number 1, is 12½ percent appropriate? No. 2, how do you establish value? And I think what is coming out here is a very real question whether 12½ percent makes sense commodity to commodity. And how do you come out on that question?

Mr. GRILES. Well, until Congress changes it, we are left with no discretion as to how much we charge except the 12½ percent.

Now, we have reduced that 12½ percent or we have reduced the royalty rate under the Mineral Leasing Act, section 39, which says that if the mine is going to bypass Federal coal or if it is going to be at the end of the mine life where the mine is just going to close down and leave Federal coal unmined, we can reduce the royalties. We have reduced them in North Dakota.

We have a special study that I have commissioned by the Bureau of Land Management in Oklahoma. In Oklahoma, we don't have any Federal coal mines although we have a large segment of Federal coal there. The reason, as I understand it, from the producers as well as from the analysis that has been done, is that coal cannot compete in the market. We do have the authority to reduce their royalties on a case-by-case basis. In July of this year, 1987, we put out guidelines about how we would deal with royalty reductions on a case-by-case basis. So, that is how we are trying to deal with the authority that Congress has granted us.

Senator CONRAD. Let me go back to that question because I don't want to—I hear what you are saying. Congress has required 12½ percent as the floor. You can make adjustments in certain cases. But you have a certain expertise in this area. Your judgment—does it make sense the 12½ percent is in the law for coal as well as oil? Or ought we be rethinking the question of 12½ percent with respect to coal?

Mr. **Griles**. Mr. Chairman, I am not the greatest expert. I will have to confess——

Senator **Conrad**. Well, I want to hear your answer, and then I'll decide if you are the expert or not.

[Laughter.]

Mr. **Griles**. I'm trying to avoid the question. No.

The fact is that 12½ percent may in some instances be too high to allow coal to compete within the fuel market that it competes in. We have the authority, and we have defined how we would use that authority on a very limited basis.

From a national energy policy viewpoint, should we be trying to promote coal at a much higher level? And should this 12½ percent be less? In order to do that, it's an issue I think you will have to address within the context of that question. The coal that is being marketed out or being supplanted in the market today in many instances is being supplanted by natural gas which may be coming from producers in Oklahoma, coming from producers in New Mexico or other parts of the West. So, the question really is should we interfere in that market that is working there? I think that's a fundamental question. At this point the Administration's position is we have allowed that market to work as it has chosen to work.

There is no question that there is a surplus of electrical power there. Some of that surplus comes from the north, from Canada, as you well know, and as your governor has so amply explained to me.

[Laughter.]

We are cognizant of those issues. The Secretary of the Interior himself spoke to those issues and believes we should be aware of them.

Should we begin to look at changing the factors that have influenced this market? I think that is something that we have to do very carefully and with a great deal of study.

Senator **Conrad**. Let me just say that you are an expert in this area.

But let me just say that we have already interfered. In 1976 we went from a cents per ton to an ad valorem basis, and we put in a floor. And that floor has dramatic effects in the marketplace. And so, the question really becomes does the interference that has already occurred—ought it to be revisited.

And I think for those who have got a long experience in dealing with oil and gas questions, because I come from an oil and gas State, as well as a major coal producer, there is a fundamental difference between coal and oil. And when you attempt to treat them in the same way, in effect you treat them differentially. But let me not intrude any further on your time.

Mr. **Griles**. No, that's fine, Mr. Chairman.

When you change the rules, you do have an impact.

Senator Nickles asked a question. The information that has been tentatively given—and I would like to supply it for the record on a factual base—is I think in 1976 when the Federal Coal Leasing Amendments Act passed, there were about 50 to 60 million tons being produced. Today there are about 160 million tons of Federal coal being produced.

Now, does this 12½ percent have an impact? The answer is, most of those leases weren't adjusted until just recently. The 1976 amendments passed in 1976. The true impact is only beginning to be felt today. I think when you talk about how much coal was produced in 1976 and in 1986 and 1987, you have to look at the long-term impact or the marketability of that Federal coal. It is going to compete against Canadian hydro, gas, oil, nuclear or whatever. I think those are the fundamental questions you will be looking at in a bigger picture.

You really cannot judge from the short past we have today as to whether or not that 12½ percent is really going to have a negative impact on the marketability of Federal coal. Most of that Federal coal is being reduced, as I say, from cents-per-ton leases that will be adjusted by 1991.

Let me, if I could, Mr. Chairman, submit to you three charts. I would like to have them in front of you. Do you have these in front of you? They're on the back of the testimony I think. Do you have those, Mr. Chairman?

Senator CONRAD. I don't have them. I have them now.

Mr. GRILES. Okay, Mr. Chairman.

To make sure we are speaking from the same chart, the first chart is entitled "How to Compute Royalty." I think the royalty obligation is a royalty base times percentage. Fair, simple. The question is what's the royalty base—that's what we have heard—whether it should be net proceeds or gross proceeds. It is really not difficult at that point.

You can move from there to the next chart which is entitled "Optional Deductions." As you can see, these blocks do not represent percentages. In other words, they're just for illustrative purposes, if you will, so that people who come back and say, well, your one block is bigger than it is supposed to be. That is not what they are intended to do. It's purely for understanding of the issue.

As you can see, we have gone across and tried to show if you were to take the industry's proposal, which is intended to be representative of the other allowances on the far right, and you can just add back up, you can see the royalty base can be changed by any of these deductions--royalty on royalty, AML, black lung, State severance and beneficiation. So, any of these could be deducted from the "royalty base," and then your royalty calculated on it. That's really the debate I think that the industry panel and EEI and all were presenting here today, what that royalty base should be made of.

The last chart is intended to be illustrative of the MMS approach. That's Approach A. It is 100 percent gross proceeds, and it is only using royalty as a basis. In other words, if you didn't collect royalty on royalty.

The middle approach—and I'm not sure that I understood from the industry panel. I think it is what they indicate that the State of Montana may do with its 30 percent royalty.

And the latter approach is where you would just have no royalty at all on royalty, and you would get a straight 87½ percent.

So, those are the different approaches that are in our record that we are looking at and we are analyzing. And I think that that is really important for you to understand. Since the January 1987 proposal was put in the record, we have learned a lot. We have learned a lot about product value in the sense of all of the issues.

We recognize that the "arm's length contract" definition needs to be modified. And we have proposed a new definition for "oil" and "gas" that may, in fact, have some applicability to coal. We recognize that if someone owns a percentage of a pension plan, that's not applicable and it shouldn't be. And we have stated that. BLM's definition of what is an arm's length contract says that if you own less than 20 percent, then you are presumed to be not in control and do not have control of that company; 20 to 50 percent, you may have control; greater than 50 percent, you do have control. We propose that definition within these oil and gas rules also.

So, some of the concerns that were expressed from the industry panel. we'll go back and look at what we have done on the oil and gas regulations, which we proposed about two or three weeks ago, and which will be indicative when we do get around to proposing coal regulations. We think they are indicative of what we have learned.

What will the coal regulations contain when we do propose these next time? We have a lot more work to do, and we need more input. We are going to be getting more input from the Western Governors. Governor Carruthers in New Mexico has called and asked us to visit with him on the 4th of December and we will have a meeting down there with some groups to go over what this impact would be from his State's perspective.

The take-or-pay issue was raised, Mr. Chairman. Let me just give you my personal perspective, which is not reflected in the proposed regulations. I do concur that when a take-or-pay payment is made for a penalty, whereas if it has nothing to do with future takes or past takes, then we have to look at it from a different viewpoint. But if the payment is made for coal in the ground that will be later paid to the same utility, and that contract in the future may be reflective of what was paid in the past, then we have to assume that it had an impact on the value. From a taxpayer's viewpoint, my mandate by law is to make sure that the taxpayer gets a fair return.

So, if a contract with a coal company says that they are to produce 10 million tons a year, and if they don't, if the utility doesn't take 10 million, and they pay them for 8 million and the other 2 million is reflected in it and they can make it up in the future, then I think we can get some of that value. But if it is simply for payment of the labor, the construction, the capital investment in the mine, I think that's a different situation. We are going to be looking at that in a different way.

That's how we do it in oil and gas also, by the way.

Senator NICKLES. Let me follow up on that. In oil and gas or in coal, you take a percentage of take or pay payments even though there is no commodity produced?

Mr. GRILES. Senator Nickles, in the Federal Government's litigation on take or pay, the Federal Government has taken the position that it get its royalty of the take-or-pay payment. The reason is—and obviously, with take or pay being as volatile an issue as it has been up until today, if the producer is obligated in the future in a settlement to sell that gas to that pipeline at a price, and he gets a lump sum settlement to sign that contract, that lump sum payment probably has some impact on what he is willing to sell that gas at in the future. And so, the government has taken the position in court that that lump sum payment does have an impact on that future take and that future contract.

Now, obviously, that issue is in litigation. It is before the Fifth Circuit Court of Appeals, and we will have some ruling in the near term.

Senator NICKLES. It ought to be in litigation.

Mr. GRILES. Well, it obviously is.

Senator NICKLES. Let me ask you another question. This is an interesting question. Do other royalty owners, whether it be oil and gas or coal, if there is a take or pay settlement, let's say, of 10 percent or 12 percent or whatever, but a lot of—15 percent I think that has been common settlements for take or pay liabilities in primarily oil and gas, maybe for coal too. But if there had been a settlement where there is no actual production—well, let me put it like this. I am not aware that royalty owners in North Dakota or in Oklahoma get a royalty on something that wasn't produced.

Mr. GRILES. You are probably correct.

Senator NICKLES. Well, I would be shocked if they are. And I am rather surprised I guess—not totally surprised—at the government in trying to sue to get a royalty on something that is not produced.

Mr. GRILES. I think that is a fair statement. If the producer didn't have an obligation and doesn't have an obligation to sell in the future to that guy that he settled with that gas or that coal, then I would agree with your position, and do by the way. But if that producer is obligated to sell this product in the future to this company, to the utility and/or to the pipeline, there is most likely some value reflected in that future contract for that lump sum payment.

What we are trying to do is calculate the value of the product. And the long-term contract that he enters into may be less because he got a lump sum payment. That's the position the government has taken.

My position is that if that producer settles his long-term contract for 10 cents on the dollar, walks away, and can operate in a free market in the future without having to sell it to a utility or to that pipeline, then we shouldn't get any royalty on that settlement.

Senator NICKLES. I think you are going to be in litigation for a long time in trying to get royalties on minerals or commodities that aren't produced.

Mr. GRILES. I understand that and have been told that. It is obvious the position has taken since these take-or-pay contracts started in 1982, and that's how long the government has had its position within this litigation.

Senator NICKLES. It would be interesting too to see other groups that I happen to be familiar with, the National Royalty Owners Association, et cetera. If you are successful, I could see you opening up a quagmire that would never end.

Mr. GRILES. The take-or-pay issue is a quagmire that may never end without our litigation, and it is an issue that, obviously, the Administration would like to get resolved. And FERC is doing its best to try to get some of these issues behind us.

Senator NICKLES. Those efforts to collect royalties on the take or pay settlements may exacerbate those settlements. And that's another problem that some of us have been working on with FERC and others in trying to encourage the parties to come together, to make settlements and to become competitive. If you compound that by a 12½ percent royalty—again most of these settlements are expensive. In some cases they are very expensive both to producers, who have I guess a contract that they are expecting some receipts on, and certainly to the purchasers. You are just going to compound their problems I think if you are successful. And that would concern me as well. A lot of us have been trying to encourage the—in other words, we have been encouraging private party settlements of take or pay issues without a mandate so much either from FERC or certainly from Congress. And again, I think if you would have a royalty as an add-on, you are just making that that much more difficult to happen.

Mr. GRILES. Senator Nickles, I don't disagree with your analysis of what may, in fact, occur. But what we have tried to do with administering this royalty program is immediately when we recognized that I met with the industries involved. They asked us to make it a final action of the Department so they could get in Federal court and have this litigated as soon as possible so that we could get some certainty within it. And that occurred last January.

Senator NICKLES. In which court?

Mr. GRILES. There are two different opinions: one from Eastern Louisiana and one from Western Louisiana. Now, if I'm wrong, I'll correct it by a note to you as to which jurisdiction. One has ruled yes; one has ruled no on the ability to take royalty on take or pay. Therefore, it is before the Fifth Circuit Court of Appeals to try to get some certainty as to what it is.

Let me just make a comment about lignite coal, if I could, Mr. Chairman, because I do think that the question you raised, as well as Governor Sinner, is an interesting question, and that is where lignite coal, which has a significant lesser BTU value, therefore in a true market would not have as great a value, sells for or is valued at a much higher value because of the contracts that are involved. And they are cost plus contracts.

One of the questions I asked—and I haven't truly any real good feedback—is whether or not cost plus contracts represent value or should we use those? It is a question we have asked, and I really haven't got a good answer for it. Should we try to use other contracts that are not for mine mouth facilities? Mr. Martin from Western Energy has mine-mouth facilities. He sells the same coal to Minnesota. So, from my perspective, I would be happy to accept his Minnesota contract as reflective of a mine mouth contract. But we don't have that in lignite. You don't ship it long distance for market purposes. So, we have the same situation with other mine-mouth facilities.

I would be interested, as we move forward with this process, in what other thoughts we could get on how do you best value that product which is not representative by the very contracts that are there?

Senator CONRAD. If you can just hold on that point. I was a State tax commissioner for 6 years and before that the assistant for 6 years. I have dealt with this issue for 12 years over and over and over. And it really does seem highly inequitable that lignite—if we were just in an open market bidding situation and it was lignite versus sub-bituminous, it would be no question what the relative value would be. Absolutely no question sub-bituminous would be substantially more valuable than lignite. And then because of the particular circumstances that we find ourselves in, you get a royalty amount that is two or three times as much on lignite as on sub-bituminous. Something is wrong.

And I commend you for your interest in this and for an examination of how we might deal with it equitably and rationally so that we get a result that makes sense.

Any further——

Mr. GRILES. One other comment I think would concern the industry's submission to you today; we have not had a chance to review it as yet. In fact, we are getting it today also. We will be happy to do an analysis to see—maybe we didn't understand their proposal. Maybe they have another way of calculating it or maybe our people miscalculated it. But we would be happy to submit it for the record as soon as we can do that analysis as to our understanding of what their new calculations reflect.

Senator CONRAD. We would very much appreciate that.

And just an initial reaction—the numbers that we have received from you on their proposal is that it would mean an $80 million reduction. Their calculation is a $38 million reduction. And as I heard them, they are indicating the major difference is how you calculate what the royalties would have been. They are saying a much higher calculation from MMS than what their calculations would indicate.

I know that you have just heard this. I don't know if you have had a chance to have a reaction or not. I will give you a chance here.

Mr. GRILES. I really, in fairness to their proposal and their numbers, would rather have an opportunity to have a good analysis done.

Senator CONRAD. All right.

Mr. GRILES. And in fact, Mr. Chairman, we will meet with them to go over their numbers to be sure that we do understand their proposal and we do have an understanding.

The MMS analysis was based on 1986 reports from industry mine-by-mine in the West calculating what was reported for value and royalty extrapolated out to 1990. That is how MMS did that. Those numbers were provided to industry in September. So, we are glad to get the feedback. We will be happy to provide that to you.

Senator CONRAD. Well, we appreciate that. And we appreciate your testimony here this morning.

Any further questions?

Senator NICKLES. Just a couple of final questions.

You mentioned in opening we have 125 producing Federal leases.

Mr. GRILES. That's correct.

Senator NICKLES. And 98 of those have been adjusted?

Mr. GRILES. I think those are the figures. Yes, 98 of the 125 have been adjusted—have royalty rate adjustments on them.

Senator NICKLES. Have you had some Federal production shut in the mine because of the increased royalty?

Mr. GRILES. There have been instances of where Federal coal would have been bypassed if we had not have reduced the royalty rate according to the producer. Now, it's kind of like who is going to blink first.

Senator NICKLES. So, in those cases where it looked like it might be that marginal or that tentative, you have made a reduction in royalty so they could continue production?

Mr. GRILES. That's correct.

Senator NICKLES. In how many of those 98 cases has that been necessary? Do you have——

Mr. GRILES. I can submit that information for the record. I only know of three or four or five. One wasn't a Western Energy lease, but Western Energy bid a royalty rate in 1978 or 1979 of 21 percent for that particular lease. That was the rate they bid on the lease. We reduced that to a lesser rate. I think it was 14. Maybe it was 12½. I think it was 14 in order to make sure that coal wasn't bypassed. It was obvious that it was expensive coal within the market of 1985-86, that it would have been bypassed. And it made sense for a resource manager to have that coal mined at the existing facility within that mine plant. So, we reduced it.

The one in North Dakota was a simple example. As I'm sure Senator Conrad can tell you, that coal there is spotty. It is not uniform. It isn't in uniform layers. It is blocked. And it was going to be bypassed. Once bypassed, it would have never been mined. So, we reduced that particular royalty.

We had a very unique situation in Colorado in which we reduced the royalty on a surface mine there also.

Senator NICKLES. But just a few cases.

Mr. GRILES. Yes, just a few cases.

Now, I think we had about 27 cases before us in July when we put our regulations out, our guidelines out, about how we will deal with future royalty rate reductions. They say, now, based on these new guidelines, go back and resubmit your proposal on that basis because most of them had simply been a letter, we want a royalty reduction. So, those guidelines have specific steps one is to take. If only to a certain level, it is easier. If it is below a certain level, it is more difficult and more financial information is required.

So, I don't know how many are pending today since we put that July guidelines out, which I think is the standard we need to provide.

Senator NICKLES. One final question. Underground or deep coal has what percent? Eight percent?

Mr. GRILES. Underground coal was not specified by legislation. It was up to the discretion of the Secretary.

The Secretary in writing the rules indicated that the royalty rate for underground coal would be between 5 and 8 percent on a mine-by-mine basis. In making the deep mine leases, as well as the readjustments of existing leases, the pre-1976 leases, the Secretary has uniformly said all deep mine coal will be 8 percent. In the past two months, a Federal court has ruled that we have to look at each mine at the point of readjustment—each deep mine, that is—to determine whether it should be 5, 6, 7, 8 or some parameter between. We are now looking at that issue.

We only have deep mines for Federal coal in several States. But the majority comes from Utah and Colorado, a little bit from Alabama.

We are looking at whether or not we should do it on a percentage basis; that is, should all deep mines be 5 percent, 6 percent, 7 percent, 8 percent—or if we are going to do it on a case-by-case basis, how should we do it? What should be the standards? Most Federal deep mines have more than one lease. In other words, there may be three or four leases within that one deep mine. Is the coal better in one part of the mine than others? Is it easy to mine? We could really make this a very complicated program to administer, which isn't my desire.

Senator NICKLES. I would also think the uncertainty would certainly cast a greater cloud over development. But I'm kind of interested in the difference. Why have the difference between the deep mines and strip mines?

Mr. GRILES. The effect of royalty rate for deep mine coal—that is how many cents-per-ton royalty is normally paid—is a lot higher. Deep mine coal is usually more costly to produce on the average. I'll give you a number of $20. But let's assume that it is two to five times higher to produce deep mine coal.

Therefore, normally when you have a higher cost product to produce, you will take a lesser royalty. I assume that was the understanding and the reasons that Congress did that and gave that authority to the Secretary. That is how we have used it.

Therefore, if you would assume that the coal is selling for $20 a ton for deep mine, $5 a ton for surface mine, 12½ percent of $5 versus 8 percent of $20, you are still paying a lot more royalty for deep mine coal than you are for surface.

Senator CONRAD. Wouldn't that same rationale hold for lignite?

Mr. GRILES. For lignite coal? One could make that argument.

Senator CONRAD. You have just made I think one of the most brilliant arguments for——

Senator NICKLES. You're becoming more of an expert. [Laughter.] But the same thing. I mean, I am thinking of Oklahoma coal that has a 28 inch seam or a 30 inch seam. It is rather expensive to produce as well. I don't know where you stop.

I mean, we had somewhat of the same thing when we did NGPA for gas. We came up with all of these absurd different price ceilings for different levels of gas. And it was just an asinine procedure that is still wreaking havoc on the natural gas industry.

And I would hate to have us do inversely the same thing through royalty management. To some extent, I can see a real problem. Where you have the Federal Government trying to make these economic decisions, it could certainly complicate the marketplace.

Mr. GRILES. There is no question that is very true.

I think that in terms of Oklahoma coal, your analysis is correct. It is high grade coal, metallurgical coal in many instances. But the metallurgical coal market is for steel and there isn't a lot of that around right now.

The question we have and we are looking at—and I've seen the draft study, but it needs a tremendous amount of work—was based on something you asked last year. You asked us to look at whether or not these Federal coal rates for coal in Oklahoma were reflective of what should be to meet the market down there because the State rates, as well as private rates, are significantly less. We are a small player in Oklahoma in comparison to private coal, and that is what this study is looking at.

Senator NICKLES. I appreciate that. Thank you, Mr. Chairman. Thank you, Mr. Griles.

Senator CONRAD. Thank you, Mr. Griles. We are going to submit some additional questions for the record. We will submit them in writing. And I again want to thank you for being here this morning and providing the testimony, and we look forward to receiving the additional analysis on the industry's proposal.

Mr. GRILES. Mr. Chairman, we will look forward to it. Thank you.

Senator CONRAD. Thank you very much.

Next we are going to hear from David Masselli, Western Organization of Resource Councils, and Don Wharton, Assistant Attorney General for the Navajo Tribe, Navajo Nation, Window Rock, Arizona. Welcome.

I want to also indicate at this time that the Western Governors Association that was going to be part of this panel was unable to send a representative this morning. We understand that some of the western States are going to submit statements for the record.

We also want it known that other parties have also expressed an interest in submitting statements and for that purpose, the record will remain open for 2 weeks.

Mr. Masselli, if I am pronouncing your name correctly.

Mr. MASSELLI. That's exactly right, sir.

Senator CONRAD. Proceed. I want both of you to know that your written statements will appear in full in the record. And if you could summarize in the interest of time, and then we have a chance for some questions, we would appreciate that.

STATEMENT OF DAVID MASSELLI, WASHINGTON COUNSEL, WESTERN ORGANIZATION OF RESOURCE COUNCILS

Mr. MASSELLI. Mr. Chairman, I will summarize. I appreciate the opportunity to present the views of the Western Organization of Resource Councils, including its affiliates, the Northern Plains Resource Council and the Dakota Resource Council, on this issue.

Our interest in this issue is a very simple one. As residents of areas impacted by Federal coal development, we have an interest in the collection of Federal coal royalties which, as you well know, under section 35 of the Mineral Leasing Act 50 percent of those royalties are returned to the States to fund educational programs and other forms of impact aid.

I would like to digress just a moment from my written testimony to talk about an issue which you have raised which goes back to the Federal Coal Leasing Act Amendments of 1975 and the imposition of the 12½ percent royalty.

I think it is important to recognize that from the beginning of time, or in the case of coal from 1920 until 1970, the Federal Government was imposing royalties on a cents per ton basis. And they were imposing it on a product that had a remarkably stable price. From the end of World War II till 1970, the national selling price of coal didn't vary by more than 10 cents up or down except in strike years. And the royalty that they were imposing worked out to be somewhere in the 9, 10 or 11 percent range. They were imposing 25 cent a ton royalty on coal that was selling for $2.

We went into a moratorium in 1971, and when we got out of it in 1976—we actually didn't get out of it until 1978—we discovered that coal prices had quadrupled or more. And we moved to this ad valorem system because the Congress essentially said, we are in a new ball game with energy prices. Let's make sure we don't ever get stuck again with what we thought was a 10 percent royalty becoming a 1 percent royalty.

Senator, on the issue of the valuation, I follow and our organizations follow what we call the "original intent theory" of FCLAA, that if the statute says a 12½ percent royalty on the valuation of coal, then that seems to mean that if you sell coal for a dollar, you should pay 12½ cents in royalty. What we are really looking at today is a quarrel between three methods: what the statute says, which is 12½ cents on the dollar; what the Department of the Interior has offered, which is about 11½ percent on the dollar; and what the industry has offered, which is 8 cents on the dollar give or take a bit. And that is big money.

The numbers that you heard earlier are based on this year when, as Assistant Secretary Griles stated, we still only have about half the coal readjusted. When you go out to 1990, you are looking at $100 million or more a year, and that is $50 million to the Federal Government. And for a decade, that's a billion dollars. If there is a problem with the royalty rate, I think that should be addressed by Congress and we should look at do we want to give up that money, and if so, where we are going to get it from.

We generally believe that the regulations that the Department first issued on January 15 for the most part embody the common sense principle that if you sell for a dollar you should get 12½ cents. We disagree insofar as the Department would have reimbursements for black lung taxes excluded, reimbursements for abandoned mine fees, reimbursements for State and local taxes. We make the analogy—and perhaps it is incorrect, but that analogy that coal like many other products sold based on a tax—when you buy something for a dollar from Woolworth's and pay a 4 cent State tax, that dollar includes a lot of taxes already. But you still set the price based on the selling price.

We think that where the industry has a point that the Department may want to examine further is that in going from the selling price of the coal to the notion of gross proceeds, the Department has made a series of adjustments. They have made some downward adjustments removing black lung, removing AML. They have made some upward adjustments. And we are not certain, as in the issue of take or pay, that all of those upward adjustments are correct.

They have also created a very floating system where it is difficult to figure out where in the process you assess the value of the coal. And we find the industry's arguments that that system should float a little less to be rather persuasive. We do not find the general thrust of the industry's argument that you should go from the selling price of coal or the value of coal to the gross depletable income from property under section 613 of the Internal Revenue Code to be at all persuasive. If Congress had wanted something along those lines, it could have done that.

And I think that is basically where we stand on this issue. Thank you very much.

[The prepared statement of Mr. Masselli follows:]

STATEMENT OF

THE WESTERN ORGANIZATION OF RESOURCE COUNCILS

ON

COAL PRODUCT VALUATION REGULATIONS

BEFORE THE

SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT AND PRODUCTION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

by
David Masselli
Washington Counsel

November 16, 1987

MR. CHAIRMAN, I appreciate this opportunity to present the views of the Western Organization of Resource Councils ("WORC") on the coal product valuation rules proposed by the Department of the Interior and the alternative plan forwarded by a coalition of coal producers and power companies. I am sure that many may wonder whether a western citizen group has either interest or expertise concerning this relatively complex issue. WORC and its affiliated organizations[*] bring both to this debate:

> As residents of areas impacted by federal coal development, we have a direct and compelling stake in the collection of federal coal royalties, fifty percent of which are returned to the States to fund educational programs and other forms of impact aid.[**]
>
> As participants in the legal and legislative battles through which our national policies on coal production have been forged, we have followed closely the Department of the Interior's abysmal performance in

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[*] The Western Organization of Resource Councils (WORC) is a regional association composed of four citizen groups: the Northern Plains Resource Council (Montana), the Powder River Basin Resource Council (Wyoming), the Dakota Resource Council (North Dakota) and the Western Colorado Congress

[**] Section 35 of the Mineral Lands Leasing Act, 30 U.S.C. 191 states that of the funds collected as royalties "50 percentum thereof shall be paid by the Secretary of the Treasury as soon as practicable after March 31 and September 30 of each year to the State other than Alaska within the boundaries of which the leased lands or deposits are or were located; said moneys paid to any of such States on or after January 1, 1976, to be used by such State and its subdivisions, as the legislature of the State may direct giving priority to those subdivisions of the State socially or economically impacted by the development of minerals leased under this chapter, for (i) planning, (ii) construction and maintenance of public facilities, and (iii) provision of public service." Pursuant to this provision, each Western coal producing state has developed a formula for allocating MLA funds. Each State has designated significant portions of the funds to a combination of localized impact assistance, public school funding and highways. see U.S. Congress, Office of Technology Assessment, An Assessment of Development and Production Potential of Federal Coal Leases, GPO, 1981, pp.352 -354.

administering the royalty program and collecting royalties owed the government. We first alerted the Congress to the failure of the Department to readjust nearly 150 leases, which cost taxpayers more than $180 million.* Our computerized coal lease database is second only to the Department's in terms of its detail on the coal program.

We have not previously submitted comments to the Department of the Interior on this matter because we were in general accord with the written comments on the proposed regulations presented by the Western Governors. But we have followed the progress of this rulemaking with interest and have submitted rather lengthy comments on other Departmental initiatives involving coal royalties.

The Real Issue is Royalty Rates Not Valuation

MR. CHAIRMAN, the dispute over the coal product valuation rules is not an arcane debate among accountants or tax lawyers and we do not intend to address it that way in our testimony. It is, unfortunately, just one more chapter in the coal industry's frantic, decade-long struggle to keep from paying a fair royalty for the use of public coal. The bottom line for the coal industry in these regulations is how much they can shave off the 12.5% royalty Congress mandated in the Federal Coal Leasing Act Amendments of 1976 ("FCLAA").

On January 15, 1987, the Minerals Management Service proposed rules that could have cut $20 - $40 million per year off the industry's royalty bill. But this was not enough for the industry. By their own testimony, proponents of the aptly acronymed Joint Industry Plan - "gyp", for short - claim that their alternative proposal would slice 33% from that statutory royalty. Our analysis indicates that the cut could significantly higher. This would cost hard pressed federal and state treasuries more than two billion dollars during the next decade.

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* The inexcusable failure of the Department of the Interior to readjust many outstanding pre-FCLAA leases to the 12.5% royalty was originally brought to public attention in WORC's 1985 testimony before this subcommittee. In response to questions from Senator Johnston, the Department admitted that the problem existed, but disputed our assessment of its magnitude. Since that time, the General Accounting Office has confirmed the true scope of the problem. In its recent report Mineral Revenues: Coal Lease Readjustments Remedied but Not All Revenue is Collected, GAO/RCED-87-164, August, 1987, GAO estimates that the waived readjustments of 149 federal coal leases could potentially cost the government up to $187 million in royalty payments.

When push comes to shove and proponents of JIP are confronted with the reality of this cut, they retreat into a tired song and dance over the "unfairness" of the FCLAA royalty. Well, if the royalty rate is unfair, let the industry make its case to Congress. Let it place this proposed windfall for large oil and energy companies on the legislative agenda and subject it to a budget analysis and the scrutiny of Gramm-Rudman-Hollings. Let it fashion a reconciliation bill to recoup the lost revenues. Let it go before State legislatures and tell them which impact funds should be deleted, how much less should be devoted to schools and roads and libraries.

The industry will not do this because the case for unfairness can not be made. A decade of practiced poor-mouthing by the well-heeled representatives of the coal industry can not totally obscure the true facts concerning federal and western coal. In the last year before the passage of FCLAA, federal coal production totaled 26.5 million tons and sold for $165.5 million. In 1986, federal coal production had soared to 163.9 million tons, selling for over $2.4 billion dollars. *

Even now, the industry only pays a 4.4% average royalty on its federal coal. But final conversion to the 12.5%/8% FCLAA level is expected by the end of this decade. At today's price and production amounts, the Joint Industry Proposal could lower total royalty payments by $72 million dollars. By 1991, the effect would be to lower royalty collections from $120 - $180 million per year. **

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* 1975 coal data is from, U.S. Geologic Survey, Conservation Division, Federal and Indian Lands Coal, Phosphate, Potash, Sodium and Other Mineral Production, Royalty Income and Related Statistics, June 1980, p.36. 1986 coal data is from U.S. Department of Interior, Federal Coal Management Report: Fiscal Year 1986, June, 1987, p.27. Federal coal data is traditionally reported by the Department on a fiscal year, rather than calendar year, basis.

** Based on potential royalty collections under the existing system as forecast by the Office of Technology Assessment., see U.S. Congress, Office of Technology Assessment, An Assessment of Development and Production Potential of Federal Coal

For a decade, the fastest growing segment of the coal industry has been the Western mines. The largest, most efficient and most profitable coal mines in the world are located on federal coal leases. They are hardly a fit beneficiary for royalty-based welfare.

The industry has trotted out a host of studies which claim to show that imposition of the legal royalty will lead to skyrocketing electric rates, close down mines, dry up a coal export market and shift energy demand from Western coal to imported oil. We have been somewhat remiss in analyzing all of these studies, having assumed on the basis of the studies presented to this Committee last year that the Western oil, gas and coal industries would already be shut down and bankrupted by the failure of Congress to repeal Sections 2(c) and 3 of the Mineral Leasing Act.

Let's place some simple truths in the record today:

Coal baseload plants are not going to burn imported oil whatever the royalty.

Most (almost certainly all) Western coal would not be a candidate for export even with no royalty.

A maximum 12.5% change in the price of fuel can not cause more than a 2-3% change in the price of generated electricity, if that.

Federal coal, going for spot prices as low as $3.50/ton, is now the cheapest coal supply in the West and will continue to be, even with a 12.5% royalty.

Almost all other holders of Western coal are moving to 12.5% royalties, as soon as they are legally able to do so.

A power company facing a $4/ton increase in the royalty amount for its

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Leases, GPO, 1981, p.352.

coal would be better served by examining the procurement practices which locked them into buying $32/ton coal than seeking subsidies from federal and state treasuries.

In short, MR. CHAIRMAN, we don't buy these scare tactics. The Western coal industry is alive and healthy. We recognize that not every mine, not every coal company is prospering. But that is a function of the strength of the industry, not its weakness. Competition creates losers, as well as winners. Marginal operations will not be saved by royalty reductions, because their competitors will receive them also. Changes in transportation patterns and prices have turned some past winners into losers. The economic impact of these changes dwarfs imposition of the proper royalty.

We are not eager to increase utility costs. But we see no reason to subsidize them either. The presence of the utilities as players in this debate may lead some to conclude that fair royalties somehow hurt consumers. Presumably, the utilities, as purchasers of coal, have interests antithetical to those of coal producers and their presence is supposed to indicate that more than production profits are at stake. But many utilities do own coal leases, so that argument breaks down.

We find the arguments advanced by the utilities simply not credible. The claim that they negotiated royalty pass-throughs with no protections and have been 'taken by surprise' by the FCLAA royalties can not be believed. The Department has been readjusting leases since 1940. By the early 1970's, cent-per-ton royalties were already at the 12.5% level based on the then selling price for coal and the Department had indicated its intention to shift to an ad valorem royalty for new and readjusted leases. Clearly, utilities were on notice that royalties were a significant portion of the coal price and were subject to readjustment. Their failure to structure prudent agreements should not justify ransacking the Treasury. Perhaps the involvement of the private utilities in this effort to lower effective royalty rates is based on self-protection: hoping to forestall decisions by State Public Utility Commissions that entry into contracts which passed through royalty costs was imprudent and such costs should properly be borne by shareholders, rather than ratepayers.

We don't buy the argument that minimal changes in coal prices due to royalties will suddenly cause coal use -- or even Federal coal use -- to nosedive. Fractional price differences will determine which coal source is used, but very likely will have little impact on whether coal is used. Coal will be backed out as nuclear plants come on line, because the rate penalty for not operating such plants is suicidal. But the number of nuclear plants in the pipeline is relatively low and the number of new nuclear plants is zero.

The same economic realities will drive most utilities to maximize use of their baseload coal plants. Significant use of imported oil for electric generation is almost nonexistent in the markets for Western coal and natural gas generation for peaking purposes fills a niche rarely occupied by coal. To the extent that new baseline natural gas plants will be constructed and back coal out, Congress crossed that line with its repeal of the Fuel Use Act. In some areas, natural gas will capture that market and would do so even if the federal royalty was entirely removed.

So we face the prospect of competition for utility coal contracts between federal and non-federal coal. Will fair royalties cause federal coal to loose out, thereby lowering total royalty collections in a self-defeating manner? Hardly.

We seriously doubt the non-Federal coal has any advantage because it is free from the federal royalty. As we have heard, again and again, from the Department when justifying further leasing, federal coal is the key to efficient mining of non-federal coal in many areas of the West because of the separated land holdings. Most private royalties are at the 12.5% level or will be as soon as they can readjusted. The dominant price factor in the cost of coal is the transportation cost. Differences in transportation costs far outweigh royalty differences.

And finally, to the extent that coal costs make a difference, federal coal can compete. In fact, it can 'knock the socks off' of most non-federal coal. It is the large federal mines on the major rail lines that are today's low cost producers. They are the biggest, the most efficient, the most profitable mines. They are the most able, should the need arise, to shave their profit margin in order to secure a contract.

Of course, these large producers would rather not have to lower their profit margin in order to keep current prices, they would rather lower royalties. Hence the initial industry reaction to the January coal valuation regulations: because the details of the regulations might have boosted the royalty rate right to the legal limit, but more importantly because it gave a signal that, perhaps, after decades of woeful -- if not scandal ridden passivity -- MMS was actually going to make an effort to collect royalties.

The theme of the industry counterattack was inspired: use a debate over details in order to put forward a plan which would roll back rates. As we prepare our testimony, we have no idea whether the plan was successful or not. Certainly, the Department's unprecedented decision on August 12, 1987 to put the Joint Industry Proposal out for public comment indicates a possibility of success.

How Coal Should Be Valued

We begin with a simple and common-sense premise. For most purposes, the value of coal should be its selling price. And for the most part, we believe that the MMS regulations, at §206.259(b) [*], implement this principle except insofar as MMS seeks to exclude reimbursements for black lung taxes or abandoned mine fees from the selling price at §206.251(k).

A powerful emotional argument can be made that inclusion of these two items constitutes a 'tax on a tax.' But the selling price of an item subject to tax almost always has embedded within it payments by the seller for other taxes, charges and so forth.

If Congress had only wanted to place a royalty on the 'net proceeds' of coal or on the profits from the sale of coal, it could have easily done so and it would have used language far different from that contained in 30 U.S.C. 207(a). At the time that FCLAA was passed, the black lung tax already existed and many states had imposed some form of severance taxes. So Congress was quite aware when it put a 12.5% royalty on coal that the royalty would be imposed on a price base which included several kinds of taxes or government levies. Perhaps that explains why Congress chose to give coal a lower royalty than oil.

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[*] We do not specifically address, in the remainder of our testimony, the procedure used in §206.259 (c) and (d) to determine the 'reasonable value' of coal which is not sold pursuant to an arms-length contract. In our view, this reflects a reasoned attempt to construct a shadow 'sales price' for coal sold under these conditions which still leaves open the adjustments to be made to that price in determining 'gross proceeds.' Our comments made below also apply to the valuation of coal not sold under arms-length contracts to the extent that, once a shadow price is determined, the adjustments to determine gross proceeds must still be made.

One thing Congress clearly did not intend was to impose a royalty only on the 'depletable income from property' as defined by Section 613 of the Internal Revenue Code. That provision existed in almost precisely the same form then as it does know and could have been easily referenced in FCLAA. But Congress did not want to use this income tax concept for coal royalties any more than it wanted to use it for any other mineral royalty. Nor, to the best of our research, has any private lessor collecting royalties.

In our view, the use of depletable income from property as a base from which to assess royalties would be illegal and bad policy. That is the easy question. The more difficult question is whether or not any of the items included by MMS as "gross proceeds" are similarly beyond the bounds of the definition of 'the value of coal.' We retain an open mind on some of these items, such as whether royalties should be assessed on payments under take or pay contracts or on payments for certain kinds of processing. Similarly, we have some sympathy with the industry's desire to set a specific point in the process at which final value should be determined.

We believe that MMS should respond to the Joint Industry Proposal on these matters of adjustments to gross proceeds and the timing of valuation. Its response should be published in the Federal Register for further notice and comment. MMS should also provide -- for public comment -- its estimates of the revenue impact of various proposals, so that Congress, States and citizens will know the likely revenue impact of new rules when they are finally implemented. In brief, we do not believe that we have reached an appropriate point for the publication of final rules on coal product valuation.

Conclusion

The thrust of the January 15, 1987 MMS rulemaking was appropriate, except insofar as it sought to drop reimbursements for black lung taxes and abandoned mine fees from the valuation base. We totally reject the methodology adopted by the Joint Industry Group, an approach which has no basis in law and which would deprive the federal government and states of hundreds of millions of dollars a year.

The valuation regulations, however, are only a small portion of the royalty collection effort. We are still not convinced that the Minerals Management Service has any desire to collect the royalties owed. We want MMS to explain how royalty collections can grow by less than four percent when federal coal production leaps by 25% and the price of that coal grows proportionately. We call on MMS to make public lease-by-lease royalty assessment and collection data so that Congress, the States and the public can determine whether their interests are being protected by MMS.[*]

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[*] Until the early 1980's, the Department of the Interior routinely made available mine-by-mine royalty payment statistics. In recent years the Department has refused to do so. This creates a situation where it is close to impossible to monitor the royalty collection process.

Senator CONRAD. Thank you. That's excellent, concise understandable testimony. It's nice to get that here.

Let's proceed to Mr. Wharton, if you don't mind, and then we will come back to questions. Mr. Wharton?

STATEMENT OF DONALD R. WHARTON, ASSISTANT ATTORNEY GENERAL, NATURAL RESOURCES, THE NAVAJO NATION

Mr. WHARTON. Thank you, Senator. We appreciate the opportunity to provide testimony to you this morning on behalf of the Navajo Nation. I am the Assistant Attorney General for the Natural Resources Division of the Tribe's Department of Justice.

We have several concerns that relate to the proposed regulations from MMS. As is so often the case, we begin from the position that there is a very special relationship that the United States has for Indian Tribes, and that relationship informs in very many, particular and important ways the considerations that are before you this morning.

It is this special obligation that gets reflected in how contracts actually get put together between the industry and the tribes for the development of coal. Those contracts, of course, are oftentimes, at least in the past, negotiated by the Federal Government on behalf of the tribes, and even in present day activities where the tribe does a lot more of its own negotiation, those contracts go to the Federal Government for review and approval ultimately.

Many of those contracts, when negotiated by the Federal Government and even those renegotiated more recently by the tribe, incorporate the Federal formula for production of royalty. So, we have the United States Government as the trustee looking at contracts, negotiated by tribes that incorporate a Federal formula. So, while those regulations that are being proposed do no expressly set the royalty rate for tribes, they certainly do affect tribes by way of the contracts that the Federal Government has reviewed and approved. So, we are directly affected in many cases by the royalty rate considerations that MMS puts forward because those contracts incorporate that formula. I think that is a real important premise to understand as we look at some of the considerations that come up for us in that context.

I also want to point out that the Navajo Nation is extensively dependent upon our revenues from coal sources. In fact, revenues from coal make up about two-thirds of our non-Federal revenues, both directly from royalty and indirectly from taxes. So, it is an important source of revenues. And when you start talking about adjusting that royalty base in any way that directly affects the income to the tribe, it is a significant impact. It is not a de minimis concern to us by any stretch of the imagination.

So, it is something that we take very seriously and something that impacts rather significantly on us even if you tend to make what appears a minor adjustment. So, the treatment of Federal regulations and how the Federal Government treats its resource is of significant concern to us both because of that direct impact and because of the relatively indirect impact of competition for the coal.

The MMS regulations have proposed changes that we think, based on the purposes that they have put forward, should be revenue neutral. They should not affect the revenues to the tribe if the goals that MMS put forward are the goals that they are truly trying to achieve here.

We do not object to revenue neutral regulations that achieve the goals that they are after that would consolidate regulations that would increase their management ability, that would clarify how royalties be paid. But when they start adjusting that in ways that have very direct and significant impacts on the revenues, particularly for the Navajo Nation, that becomes a very different matter.

We are particularl concerned about three areas in those regs: the definition of arm's length contract, the definition of gross proceeds, as we have had a great deal of conversation about this morning, and the creation of allowances that were not previously included in deduction from royalties.

With respect to arm's-length contract, we are concerned that the parties in arm's-length contract by definition have more than a mere nonaffiliation. We think that they should have a true, adverse economic interest in assuring that an arm's-length contract is reached. Senator Melcher earlier was asking that question about what an arm's length is. And we explained that is two parties who sit down at the table who have a real adverse economic interest so that they are truly arriving at an arm's-length negotiation. Parties such as coal companies and mine mouth facilities with utilities do not necessarily have that same arm's-length adverse interest even though they may be nonaffiliated. So, we think the definition that MMS is considering——

Senator CONRAD. Let me stop you there. Give me an example of why that would be the case.

Mr. WHARTON. Sure.

Senator CONRAD. How is that the case that a utility that is buying electricity from a mine mouth—why don't they have fundamentally different interests?

Mr. WHARTON. They don't have a fundamentally different interest because the price that is being paid is passed along to the consumer of the utility or the electricity. And so, if they can reach an agreement, as some of them have, that they will return a payment to the company based on a capital investment that the company makes—the coal company now or the supplier—they are not dealing on the same basis as trying to value the coal in terms of the actual sale of the coal. The miner is now getting paid in much the same way that the utility gets paid, based on capital investment and not on the actual payment of the coal so that they are dealing in a different situation than, for instance, a coal supplier that is selling to a utility and it is not a mine mouth operation where you have a real captive market. You know the mine mouth supplier is captive to that utility.

Senator CONRAD. You are really making the case, as I hear you—I just want to make sure I am understanding—that if you are on a cost plus basis, obviously that is different than something that is totally market driven.

Mr. WHARTON. Yes, I think——

Senator CONRAD. In terms of arriving at a value of the underlying resource. Is that the point?

Mr. WHARTON. I think that is part of the point. The point is that you want to get at the value of the resource from our perspective as the resource owner, and not all contracts that are negotiated for those purposes in fact are reflective of getting at that value. In fact, oftentimes the sale price itself doesn't contain all the consideration that may be part of that agreement. And that's a separate part of the concern that we have about the MMS regulations that talk about the consideration available to suppliers to which they are entitled. We also are interested in making sure that that price is part of all that the supplier gets that is accrued or accruing to the supplier so that all of the consideration is taken into account.

Senator CONRAD. Let me back up. I mean, isn't it clearly in the economic interest of the mine mouth operator to make certain that all of his costs are included in any cost plus which are not necessarily in the interest of the utility that might be a purchaser? In other words, it would seem to me that your interests coincide with the interests of the seller. Both of you have an interest in making sure everything is included. I can't think of a circumstance in which it would be to the interest of the seller to understate the value.

Mr. WHARTON. In listing all the costs, that's correct. And particularly in the case where you have a contract where they are passing that through, they want to list all of those costs because it is not going to cost the utility anything either because that gets passed on to the rate payer to the extent that the PUC allows that. I agree with that, Senator.

Senator CONRAD. So, there don't you have a confluence of interests with those that you represent?

Mr. WHARTON. In that particular example, yes, sir. I would agree with that.

Senator CONRAD. Other points that you would like to make?

Mr. WHARTON. Yes. With respect to gross proceeds, Senator, we think that gross proceeds is the appropriate standard that should be used here and that it should reflect all of the value of the coal that is part of the consideration that is paid, including the concept of accrued or accruing to the lessee all of the values that are part of that consideration.

We do not agree that allowances, for instance, such as allowances for washing should be deleted. The reason for that is because we are talking about what it takes to market this coal. The coal—that is part of the process for marketing the coal. Indeed, the industry's proposal about deleting different costs—and you can take that with any particular cost. Any cost that is attributable to producing and marketing the coal can be deducted and, therefore, make it more marketable. I mean, if you want to take that argument, you can take it right straight through the royalty itself. So, it is hard to draw a line when they start talking about reducing or deducting any cost between that and the next one that is in line.

So, we think all of these costs are appropriately attributable to what it costs to market the coal and, therefore, should be included because it is of value. I mean, it is part of the value of marketing that coal. And that is what it costs to get that coal to the purchaser of that coal at the other end of the line and therefore, is part of what should be considered in that cost.

Senator CONRAD. Would you extend that argument to every element—that is, State severance tax? I presume that you would make the argument that just as we go down and we buy Tootsie Rolls at the store, corporate taxes are included in that, State and local taxes are included in that, and that all has a sales tax applied to it. And to the extent you have double taxation, it is not out of the ordinary for that to occur. So, I would presume that you would make the point that State severance taxes ought to be included for the purposes of the Federal royalty.

Mr. WHARTON. I would, Senator, agree with exactly that and point out that those taxes, in fact, are what provide the infrastructure that is necessary to accomplishing the coal production in the first place—the roads, the police protection, all the rest of the things that are part and parcel of the ability to produce that coal. And it is a real value that is a part of that coal and, therefore, is appropriate to be included not merely because it is done in other circumstances because it has a direct value here in supporting the ability to produce that coal and is a real value of that coal and, therefore, should be included.

Senator CONRAD. All right. Did you want to make a further point on the allowances? Or had you concluded that?

Mr. WHARTON. No. That's all on the allowances.

Senator CONRAD. All right. Further points that you wanted to make?

Mr. WHARTON. There are a couple of points about the industry proposal, Senator, that we would like to bring to your attention. We very much are opposed to the industry proposal particularly to the extent that it adopts Internal Revenue Code definitions of gross profits which is not the same, of course—or gross income as opposed to gross proceeds. The whole structure of the IRS policy and the purposes for IRS policy are quite different from those of valuation of resources. The reasons for making decisions about those definitions for allocating economic benefits and burdens are motivated by different purposes than those that are for the purposes of gross proceeds or valuation of the coal resource itself.

We think that those fundamental differences are important in looking at how that should be done and, therefore, we very much are in favor of the gross proceeds approach by MMS because it is designed to get at the value issue. And these are, after all, ad valorem leases, and the purpose of those definitions is to get at the value of the resource, not to get at the income issue which is a separate consideration. And IRS has a completely different agenda for why it sets those than does MMS.

Moreover, when looking at those things, the MMS is much closer to and more conscious of its responsibilities under the Federal trust responsibility than the IRS would be at this point, and we think that it is inappropriate to bring that sort of valuation process into it.

I think that that covers the range of concerns that we would have in the briefest form. Our testimony provides other considerations. We again appreciate the opportunity to present these views.

[The prepared statement of Mr. Wharton follows:]

NAVAJO NATION
OFFICE OF ATTORNEY GENERAL
WINDOW ROCK, ARIZONA

STATEMENT

OF DONALD R. WHARTON
ASSISTANT ATTORNEY GENERAL FOR NATURAL RESOURCES, THE NAVAJO NATION

AT THE HEARING OF THE
SENATE MINERAL RESOURCES, DEVELOPMENT AND PRODUCTION SUBCOMMITTEE
ON THE REVIS~~ION OF~~ COAL PRODUCT VALUATION REGULATIONS

NOVEMBER 16, 1987, 10:00 A.M.

STATEMENT

Chairman Melcher, Members of the Subcommittee, good morning. My name is Donald Wharton. I am the Navajo Nation's Assistant Attorney General for Natural Resources. My comments today will reflect the general concerns of the Navajo Nation with regard to the proposed revised regulations on Coal Product Valuation. We have previously submitted detailed comments on specific sections of the proposed regulations to the Minerals Management Service; copies will be submitted to your staff.

The Navajo Nation currently has five coal leases with four companies yielding over 22 million tons of coal annually. Development of the Tribe's coal resources is very important to the Navajo economy, comprising a significant majority of all tribal revenues. It is critical that any revision of the coal valuation regulations insure that all royalties owed are paid and that the revisions do not result in any loss of coal royalty revenues to the Navajo Nation.

As the federal government seeks to shift ever greater shares of its obligations onto tribes, the value of non-renewable resources takes on increasing importance in an environment where the Navajo Nation faces over 50% unemployment and the average Navajo per capita income is well below the poverty level.

I. INTRODUCTION: THE FEDERAL TRUST RESPONSIBILITY TO INDIAN TRIBES.

MMS seeks to create regulations which will be more manageable and foster certainty. These are laudable goals and should be neutral in their impact on revenues. Yet they are not the vast majority of the impacts work to reduce revenues to tribes for their resources. Any proposals by MMS must be viewed in light of the trust responsibility of the United States to Indian tribes. This federal trust responsibility to Indian tribes forms the legal basis of the federal government's relationship to Indian tribes. That obligation requires more than a neutral assessment of whether the Indian's interest suffers no more than the federal interest in implementing new regulations.

Indian tribes possess sovereign powers not derived from the Constitution. Their governments and their members have a very definite and special relationship with the federal government. That relationship is based upon solemn agreements often memorialized in treaties that required the cession of millions of acres of land in exchange for specific and enforceable obligations on behalf of the United States. One of these obligations is the responsibility to manage or assure the management of tribal trust resources (in this case coal) in a manner designed to provide the greatest possible return to the Indian people or tribe involved.

Native Americans have long since learned that the United States' memory for the agreements made in exchange for the benefits it received from American Indian people is very short and requires frequent and continuous reminding. It is therefore the rule, rather than the exception, that comments such as these begin with an introduction setting forth those basic principles of the trust responsibility owed by the United States and its agents to the Indian tribes in order to set the context for the comments that will follow.

The trust responsibility existed before, and is preemptive of, the other responsibilities of the Department of the Interior. All the sub-divisions of the Department of the Interior, and in fact, all agencies of the Federal Government, are charged with carrying out the federal trust responsibility to Indian tribes. In determining value for royalty purposes the Secretary is constrained by his fiduciary responsibilities and must not show deference to the desires of industry to reduce royalty payments, nor is the Secretary relieved of his trust responsibilities because of difficulty in administration or lack of funds.

This special trust relationship imposes a fiduciary duty of the most exacting standards upon the United States as trustee. The Supreme Court has stated:

> In carrying out its treaty obligations with the Indian Tribes, the government is something more than a mere contracting party. Under a humane and self-imposed policy, which has found expression in many acts of Congress and numerous decisions of this Court, it has charged itself with moral obligations of the highest responsibility and trust. Its conduct, as disclosed in the acts of those who represent it in dealing with the Indians, should therefore be judged by the most exacting fiduciary standards. Seminole Nation v. United States, 316 U.S. 286, 296-97 (1942).

The Minerals Management Service, therefore, has an affirmative fiduciary duty to Indians in the collection of Indian mineral royalties. The

MMS must take this affirmative fiduciary duty seriously; in its every action, MMS must obtain the greatest benefit for Indian tribes and allottees. When exercising Secretarial discretion, for instance, Secretarial actions affecting Indians are limited by the Secretary's fiduciary duty. The scope of permissible actions is narrowed to one action or several possible actions whichever will be in the best interest of the affected Indian or Indian tribe.

In normal situations, a prudent person may subordinate his own interest to the interests of others; however, a trustee may not subordinate the interests of the beneficiary to any other interest. If there are conflicting interests, the Secretary's other responsibilities do not relieve him of his trust obligation to exercise his discretion in determining product value in a manner which will provide the affected tribe or allottee with the greatest return. His discretion must be exercised in light of his strict fiduciary obligation.

In Jicarilla Apache Tribe v. Andrus, 687 F.2d 1324, (10th Cir. 1982), the Court stated:

> We are convinced . . . that the plain, mandatory terms of the regulations do not leave room for deference to this interpretation, which does not serve the interest of the Indians. If there is any doubt, the interpretation should be made liberally in favor of the Indians for whose protection these provisions were promulgated.

Id. at 1332 [(citing Antoine v. Washington, 420 U.S. 194 (1975); Bryan v. Itasca County, 426 U.S. 373 (1976)].

The proposed regulations should be viewed in the light of past performance by the agencies of the Department of the Interior. The Department has consistently failed to fulfill its fiduciary obligations in valuation of royalties and in requiring the proper accounting by lessees of Indian mineral leases. See, Jicarilla Apache Tribe v. Supron Energy Corporation, 479 F.Supp.

536 (D.N.M. 1979), aff'd on rehearing en banc 782 F.2d. 1555 (10th Cir. 1986), cert. denied 93 L.Ed.2d 416 (1986).

One need only read the numerous reports of the General Accounting Office, the Linowes Commission and others to confirm the failures of the Department to supervise and audit royalty payments.

In minerals development and collection of royalties, the federal fiduciary duty requires MMS to seek the highest royalties payable under lease terms and federal regulations. The scope of permissible actions in setting valuation guidelines for royalty payment is greatly constrained by the obligation to perform as a trustee. The MMS must at that point consider what would generate the highest royalties for the tribe, even to the exclusion of other interests.

As The Tenth Circuit Court of Appeals stated in its en banc opinion in the case of Jicarilla Apache Tribe v. Supron Energy Company, supra, when dealing with Indian minerals, where the Secretary is presented with alternative interpretations or alternative actions, both of which are reasonable, his fiduciary duty requires that he must choose the interpretation or action which better promotes the tribe's interest. With respect to these Coal Valuation Regulations, the MMS' duty is not to seek what would be most convenient for the agency, or what would make implementation of these regulations the easiest for the agency, or the most palatable to industry. Instead its duty is to best promote the interest of the Indians.

The Congressional mandate governing the actions of the MMS with respect to Indian minerals is contained in the 1938 Indian Mineral Leasing Act, 25 U.S.C. §396 et seq. The stated purpose of the 1938 Act is to ensure that Indian tribes receive the maximum benefit from mineral deposits on their lands. The 1938 Act was designed to achieve the broad policies of the Indian

Reorganization Act of 1934--that tribal governments be revitalized and that tribal economic development be encouraged. See, Crow Tribe of Indians v. Montana 650 F.2d 1104, 1112-13 (9th Cir. 1981). In matters of coal leasing on Indian lands, including payment of royalties, the MMS must continually strive to keep these broad and important principles in mind, and must never lose sight of its exacting fiduciary duty to Indian tribes.

II. PURPOSE AND BACKGROUND OF MMS' PROPOSED COAL VALUATION REGULATIONS

MMS' belief that "the proposed valuation methods would yield a reasonable and long-term maximization rate of return for both federal and Indian leases" (52 FR at 1841) is misplaced and inconsistent with the decisions of Federal Courts regarding Indian leases. The Federal Courts have consistently required the United States to maximize royalties to Indian tribes and to always choose the methodology which will create the higher royalties when given two reasonable choices. See, e.g., Jicarilla Apache Tribe v. Supron Energy Company, supra. The MMS goal for Indian leases should be to adopt valuation methods that will yield maximum royalties to the Tribe; not "a reasonable and long-term maximum rate of return." The underlying premise referred to by MMS that the working interest owner is going to negotiate the best deal he can to further his own interest, advancing those of the royalty owner as well, is not always accurate. Since Indian tribal royalties may have a different valuation basis than that on which the lessee is being paid, the MMS premise fails.

Furthermore, attempting to assure maximum long-term revenues to all parties concerned is inconsistent with the Secretary's special duty to Indian tribes. This trust responsibility requires the Secretary to consider the best interest of the Indians even if a particular position taken would have an adverse effect on industry. The Navajo Nation questions how the Secretary can know what course of action would assure maximum long-term revenues to the Tribe. It appears that the intent of MMS in proposing this policy is to allow MMS to accept less than maximum royalties currently with the idea that perhaps production will last longer and in the long-run tribes would receive more money. If tribes could be assured that this is the case, that would be another matter, but there is no certainty in the current energy market. Since coal is a non-renewable energy resource and therefore cannot be replaced, the Navajo Nation expects to receive the maximum royalties for its resource at the time of production and sale.

Moreover, the Navajo Nation questions the premise that federal and Indian leases should be treated the same. Applying the same valuation standards to coal produced on Indian land and coal produced from federal lands creates problems for the United States which has a special trust relationship with Indian tribes and a trust responsibility to maximize royalty revenues. This responsibility may not be the same for federal lands as it is for Indian lands; therefore, applying the same valuation standards without additional scrutiny may result in a breach in the Secretary's trust responsibility. The maxim that "what is good for the United States is good for the Indian tribes" has not always proved true.

The Navajo Nation respectfully suggests that an additional purpose of the regulations should be to insure that the value of coal for royalty calculation purposes be consistent with the understanding of the parties at the time the leases were negotiated. There should be no change for leases that have been negotiated such that value for royalty purposes would be reduced. For example, the Navajo Nation recently renegotiated two coal mining leases with regard to the amount of royalties and taxes to be paid for past and future production. The parties relied on and negotiated on the basis of current regulations and the interpretations of the Department of the Interior. The Secretary should not now be allowed to change the methodology by which royalties were valued, as such a change would effectively change the assumptions upon which the negotiations were based. It is important for MMS to understand that any change in policy and methodology for calculation of royalties will have a dramatic effect on existing leases and the royalties that will be paid under those leases. Therefore, regulations should apply prospectively to new leases only, unless the Secretary can demonstrate that the provisions will not reduce the amount of royalties due to tribes under current regulations. The Navajo Nation insists that the Secretary demonstrate that the proposed revisions are "revenue-neutral" before any revisions are adopted.

III. SPECIFIC OBJECTIONS TO THE PROPOSED REGULATIONS

The proposed regulations are predicated on the acceptance of three major changes in the coal valuation methodology: (1) the concept of "arm's-length" contracts to determine value, (2) the exclusion of certain costs from "gross proceeds", and (3) the deduction of washing allowances from the value of coal. Each of these predicates proposed by MMS are unacceptable to the Navajo Nation.

1. Arm's-length Contracts. This definition is too restrictive and would include contracts between a mine-mouth generating facility and its coal supplies. The utility may sell energy at reduced rates to a parent or affiliated company of the coal supplier in return for reduced coal prices. Under such a scenario, although the sale of coal would be termed an "arm's-length contract," the price of the coal would be undervalued. MMS has

resisted the effort by Indian tribes to expand the definition of arm's-length contracts to require the parties to be non-affiliated with "adverse economic interests" and that agreements be made in "free and open markets."

2. Gross Proceeds. The Navajo Nation is in agreement that gross proceeds should include the total monies and other consideration to which a lessee is entitled. However, we prefer using the words "accrued or accruing to" in place of "entitled." The Navajo Nation is also in agreement with the litany of payments that would be included in gross proceeds, but it is not in agreement that reimbursements for Federal black lung fees and reimbursements for abandoned mine lands fees authorized by the Surface Mining Control and Reclamation Act of 1977 should be excluded. These two reimbursements make up a substantial part of the gross proceeds to lessees. These costs are passed on directly by the lessee to the purchaser of coal and by the power plant operator to the consumer who should rightfully bear the burden of these taxes. Neither the Federal Government nor the Indian tribe should be required to bear any of this burden but rather the consumers of the coal should pay these taxes. Inclusion of these costs does not affect the lessee or his profit and by including the costs specifically in the regulations, the lessees will be sure to pass the costs onto the segment of the economy which should rightfully bear those costs.

Additionally, the Navajo Nation would like to point out that the majority of these fees collected are used by the federal government to assist eastern miners affected by particular diseases caused by their work in underground coal mines and to reclaim eastern mines for which there are no reclamation funds. Certainly all consumers of coal products, i.e. electricity in the United States, should bear the burden of these costs and not the federal government, states with federal coal, or coal-owning Indian tribes. It is unfair to ask Indian tribes to bear these burdens.

Furthermore, the inclusion of these deductions is arbitrary. How are these costs distinguished from other production costs? Moreover, inclusion of these deductions sets a precedent for further deductions not contemplated under the original lease negotiations.

3. Washing Allowances. MMS has proposed that washing costs be deducted from the value of coal. The Navajo Nation objects to any deduction for coal washing in determining value for royalty purposes. Coal washing costs are incurred to render the coal marketable. Once MMS permits such an allowance, the precedent is set for other costs to be deducted from gross proceeds for royalty purposes.

IV. THE INDUSTRY PROPOSAL

The Coal and Utility Industries have submitted their proposed alternative regulations to MMS. The Navajo Nation has strenously objected to this proposal which represents a complete rejection of the "gross proceeds" concept advocated by MMS.

At the heart of the Industry Proposal is their reliance on the concept of "gross income" as defined by IRS regulations as opposed to "gross proceeds" as defined by MMS. While the use of IRS regulations may be appropriate for tax purposes, MMS should not accept IRS regulations for mineral product valuation purposes. The goals and objectives of the IRS and MMS are completely disparate. Tax regulations are drafted in response to multiple policy considerations which often seek a balance between revenue generation, tax relief, and administrative efficiency. MMS, on the other hand, is responsible for accounting and collecting royalties on federal and

Indian leases in accordance with applicable laws, regulations and lease agreements. The MMS, unlike the IRS, cannot promulgate regulations which shift economic burdens from one sector to another; in this case, from the coal lessee to federal and Indian lessors. Moreover, while the federal government may be willing to provide economic concessions to the coal industry in the form of tax relief, the MMS may not deprive Indian lessors of coal royalties in contravention of the federal trust responsibility. As we have repeatedly reminded MMS, revisions in the valuation regulations which do not yield revenue-neutral results, violate the trust responsibility owed to Indian tribes.

Industry's deletion of the concept of "gross proceeds" for royalty payment purposes is inconsistent with the concept underlying the present valuation regulations -- that royalties from *ad valorem* leases be based on a percentage of gross proceeds. We urge MMS to retain the "gross proceeds" methodology for valuation

When MMS proposed deductions for Black Lung taxes and AML fees, the states and Indian tribes argued that such deductions were not justifiable and would open the door for deductions of all other taxes from gross proceeds. As predicted, Industry now proposes that state and local taxes be deducted from coal production attributed to the lease. Apparently there is no limit to the deductions which could be imposed.

Industry's justification for eliminating the concept of "gross proceeds" is that costs such as taxes and fees "do not contribute to the value of the coal." This reasoning ignores the total costs allocated to coal production. Taxes support the governmental infrastructure necessary to enable a company to mine the coal -- roads, water, sewers, police protection, etc. The Black Lung tax provides some measure of health protection to coal workers, and the AML fees contribute to the reclamation of mined lands. These taxes and fees add value to coal by making the very production of coal possible.

Industry's contention that taxes and fees depress the value of coal cannot be supported. Industry's interest in the federal coal leasing program remains high. Moreover, there is no indication that coal companies have voluntarily relinquished their federal or Indian coal leases because of the present royalty valuation system. If incentives are necessary to stimulate the coal industry, the federal government can take remedial action without affecting Indian coal revenues.

Industry also contends that take-or-pay payments should not be included in the gross proceeds definition, since the lessor does not share in the financial risks of coal development which take-or-pay payments are designed to protect. This contention is without merit. Coal lessors depend, to a large extent, on the management and production capabilities of the lessee to produce and market the coal. The selection of lessees is influenced by the capabilities of a coal company, including their financial abilities. Indian lessors are heavily dependent on coal royalties and share in the financial risks of the companies.

Industry further contends that take-or-pay payments are not income and are essential for maintaining the coal operator's facilities. This does not distinguish take-or-pay payments from other forms of gross proceeds. The sale price of coal will always include some cost of maintaining the operator's facilities. The Industry proposal for take-or-pay, like their proposals for processing allowances and deductions for fees and taxes, advances Industry's apparent belief that royalty should be paid only on "net profit" to the lessee.

The Industry proposal is not revenue-neutral and would have serious impact on the royalty income to federal, state, and tribal governments. The Navajo Nation estimates that its annual coal revenues would be reduced by approximately 20% if Black Lung taxes, Abandoned Mine Land fees, and state and local taxes were excluded from gross proceeds for royalty valuation.

Industry has attempted to expand the washing allowance proposed by MMS to include additional processing necessary to market the coal. This expansion is accomplished by modifying the definition of "marketable condition" to refer to coal which has undergone the processes of "extraction, and where necessary, crushing and screening." Such a definition completely ignores washing, blending, and other beneficiation processes often required to ensure that the coal meets minimum required specifications. Industry should not be allowed additional processing deductions by lowering the threshold of processing required to meet their artificial definition of "market conditions." Regardless of the definitions, the amount of processing necessary to place the coal in a condition acceptable by a purchaser remains the same.

We agree with Industry that at the point of marketability, coal has value and royalty should be determined; however, under such an interpretation, value should be determined after all processing costs are incurred. If MMS were to accept Industry's definition of marketable condition, what would stop Industry from later claiming that allowances should be made for all processing costs and that valuation be based on the coal's value in the ground? The definition of "marketable condition" should not create the fiction that coal is marketable at any point other than where all necessary beneficiation processes have been performed.

The Navajo Nation strongly opposes any attempt to allow deductions for processing, including washing costs. Such deductions are inconsistent with the concept of value-based leases whereby the lessee is required to place the coal in marketable condition. Processing costs are included in the sale price of coal and must be included in the gross realization for royalty valuation.

V. SUMMARY

The Secretary's trust responsibility to Indian tribes requires him to maximize Indian royalties from Indian coal leases. The proposed revisions to the Coal Product Valuation Regulations by MMS and Industry would result in a breach of said trust responsibility. No revisions should even be considered until the Secretary can demonstrate that the proposed regulations will have a revenue-neutral impact on royalty payments to Indian tribes.

Thank you for the opportunity to present our concerns to your Subcommittee.

Senator **Conrad**. Well, I appreciate very much your testimony. It has been excellent. I must say all of the testimony I have heard here this morning has been extremely good.

Two questions that I would like to raise to you, and I am going to be submitting some other questions in writing for the record, if you don't mind, because we are not going to get a chance to get to all of the questions. But I want to have a full opportunity for you to make a record here.

The question of a differential, a fundamental difference between oil and gas and coal has been raised here this morning. It is an issue that I have struggled with for many years. And I think we have heard from industry and somewhat from Mr. Griles the question of the differences between oil and gas and coal. Do you see a difference between those commodities? And the natural follow-on which flows from that is ought there be a difference in the royalty rate. Is 12½ percent appropriate with respect to coal, as well as oil and gas? Do either or both of you react to that?

Mr. **Masselli**. Well, let me start by commenting just briefly on the difference between oil and gas and coal. Obviously, there are differences not only between the commodity produced, the market sold and the nature of the production. Coal is clearly more capital intensive than oil and gas.

But I think that when you go at it from the selling price issue, that at that point what MMS is looking at is a barrel of oil at $19.50—it may have cost $19 to produce—or a ton of coal at $5, $10 or $20, depending upon which kind of coal it is. And I think that at that end it is fairly irrelevant whether you are talking about labor intensive or capital intensive or whatever.

The question of whether there should be a different rate—I'll be blunt. I was around when FCLAA was passed. People were looking for a rate. They said, well, this is a natural resource, and this is a natural resource. They both burn. And 12½ percent looks reasonably good. It didn't come down on stone tablets. But I think that if one wants to change it, there has got to be sort of a case made for why the change should be made. And I haven't seen that case made, particularly one that addresses the Federal interest and the State interest which, to be blunt, is getting money out of this substance as an owner of resources.

If an argument could address that concern about why it is in the better long-term interest of the Federal Government and the States to change that, I think that that might be a useful argument to be made, but not simply an argument that we are having hard times because everyone—I have never heard anyone come before Congress and say we are making tons of money; tax us more.

Senator **Conrad**. You haven't heard that?

Mr. **Masselli**. Not recently.

Senator **Conrad**. In the 10 months I have been here, I have not heard that either. But I'm certain that we are going to have a turnaround on that question. [Laughter.]

Mr. Wharton would you like to respond?

Mr. **Wharton**. Senator, we will provide additional response. But I think that the best I can do for you now is to offer an observation.

In the past 5 years the Navajo Nation has renegotiated three of its five coal leases, all of which are operating—the three that have been renegotiated. All three of them have been converted from cents per ton to royalty base, and all three of them are now using a 12½ percent base.

None of those leases had a requirement in them that they be renegotiated. We sat down with the companies and had to negotiate and get them to accept this royalty rate, and they did in these situations. When I say that, there is one lease that did have a renegotiation clause in it, but there were two leases connected to it, one of which did not.

So, the industry is telling you that they are concerned about the 12½, and certainly on Navajo I know that they are. But they have all sat down with us and agreed to that rate within the last 5 years and are paying, most of them, that rate presently.

So, to the extent that they can and do pay it, they are paying it to us. They are selling their coal. They have not cut back on production. We do have mostly mine mouth facilities. To that extent they are more secure in the production rate. But our experience has been that the 12½ percent royalty rate does not reduce production of coal.

Senator **Conrad**. We are running out of time, and I've got one other question I want to make sure I put to you before we conclude this.

Let me just go over with you from the perspective of a consumer the differences that I see in my State between coal and oil. Oil sells world market price. It does not matter what the underlying severance tax is. It does not matter what the Federal Government does with the windfall profits tax or royalty. Oil moves in direct relationship to world market price. So, the consumer is going to pay world market price regardless of what happens with respect to State taxation, with respect to Federal royalty. That is just a truism.

Coal in my State is sold almost exclusively at cost plus. To whatever extent you add on Federal royalty, State severance, the consumer is going to feel that effect pretty directly. And understanding that coal price that includes royalty is a small percentage of electricity, which is the ultimate product and what is ultimately borne by consumers, nonetheless if you are looking at it from a consumer's perspective, there is a direct difference there between coal and oil.

What would be your reaction to that? Agree, disagree, doesn't matter in terms of what we do with Federal royalties? Do you have any reaction to that?

Mr. **Masselli**. I think what you say was absolutely true 10 years ago and will be absolutely false 10 years from now. We are moving in a direction where coal is beginning to be marketed like other commodities. That, in fact, is the point that the utility testimony made, which is if you go up 1 percent, maybe we will switch to X, Y or Z.

And I think that when you have more railroads, more mines, a utility is not in the position where it says we've absolutely got to have a 30 year contract or else we won't be able to meet our needs. Now people are buying on 2 year, 4 year, 5 year contracts, buying percentages of their coal, mixing them, and we are moving closer and closer to a market—it is not a world market. It is frankly driven by the price of sub-bituminous coal in the Powder River Basin and the railroad rates charged by the Burlington Northern and the Chicago and Northwestern which set the coal market for the West with the normal quality and quantity variations. We are not there yet. We will be there 10 years from now.

Senator CONRAD. One other question that I wanted to put to you both before we conclude. We have a unique situation in my State, and I think both of you perhaps—certainly Mr. Masselli understands—low Btu coal sold with long-term cost plus contracts. And those contracts result in—I don't know if you heard my remarks earlier—in a Federal royalty two or three times higher than what you get with other western coal even though the intrinsic value of the coal is substantially less than other western coal, sub-bituminous.

Do you have any reaction to that? Doesn't that seem unfair in terms of arriving at a value of a commodity for the purposes of establishing a royalty?

Mr. MASSELLI. I am going to submit a longer statement on this for the record. But I think the problem here is if a ton of lignite sells for $10, it is not in my mind that different from a ton of high bituminous coal selling for $10 because what you have really got is your intrinsic value has two components. Component No. 1 is how good the coal is, and component No. 2 is where it is. And North Dakota lignite has low Btu value and for many purposes fabulous locational value. And somebody is getting the $10 a ton. In fact, the last time I checked North Dakota lignite was selling for $9.85 a ton average, and Montana sub-bituminous was selling for $9.70.

There may be a second problem, and I am just going to take a second. It is the flip side of the problem that Mr. Wharton talked about. When they look at a mine mouth coal contract, they are concerned that the producer is charging less for his coal than he ought to because of the fact that he has got a deal with the utility company. There is the equal possibility, given tax laws, et cetera, that in another situation, when you look at the whole process, they may have in the past decided to allocate more of that value to the coal than it was worth, and less somewhere else along the road for tax reasons, royalty rate, revenue reasons, State PUC reasons, you name it. So, you may just as easily have over-valued coal as under-valued coal when you don't have arm's length dealing.

Senator CONRAD. Well, you have made a very good point, one that needs to be explored I think.

The value of the coal—it seems to me if you were to match lignite against sub-bituminous, there would be no question sub-bituminous would sell for 40, 50 percent more at a minimum. The advantage clearly is the transportation differential. And Montana coal gets shipped, and that's an expensive process. North Dakota coal gets used in a mine mouth situation. You have got Clean Air Act provisions that get into this whole relationship.

But somehow I am left with the sense that when you are paying two or three times Federal royalty on North Dakota lignite and sub-bituminous Montana coal, that there is a real question about whether that is equitable. I mean, should the transportation differential here be the determinant that gives you that kind of difference?

Mr. MASSELLI. Well, obviously, I am going to have to look at Governor Sinner's letter because I have not seen—I was not aware that that sort of differential existed. And apparently you are talking about an absolute differential, not two, two and a half times as much per Btu.

Senator CONRAD. No, that's right.

Mr. MASSELLI. And if that's true, then there is a problem. But I had never before this morning heard it put that way. I had had concerns expressed to me about the nature of MMS' proposed pricing of mine mouth power plant arrangements, but not about even once we agreed on what the price was, what the real value was, that there was a significant differential.

And I say this not just because you are sitting there. I don't think anyone should pay a significantly higher or lower royalty for surface mined coal than anyone else. So, we would have to look at why this situation appears to exist, and see if it does, and then what the solution is. But I have never heard of it before you read from the Governor's letter.

Mr. WHARTON. I think, Senator, that I am more inclined to look at the location of the coal as part of the issue. I think that is an important part of the issue. You are talking about getting energy to market, and if you happen to be situated closer to market, and that's a value of your resource, then you ought to be able to collect a part of that value of the resource. It is an important part of getting the value of what you own. Now, whether that is the Federal Government or the Navajo Nation or anybody else, if your proximity to market gives you an advantage, then that is an advantage that is part of the value of the resource that you are selling. And I am not offended by the notion that that value is being reflected in a royalty. I think that is appropriate.

Senator CONRAD. It is actually a little more complicated than closeness to market because it involves a whole series of coal quality issues that relate to shipability. I mean, it really gets to be a very complex calculus—clean air, increments that are available. I think you know many of the elements that get to be a factor.

You can clearly make the argument—it is not without merit—that that attaches directly to the value of the resource and that ought to be reflected in the marketplace and ought to be reflected in a resulting royalty. I think you can also, or I think reasonable people could say wait a minute now. If we are trying to get at the value of the underlying resource, the value of the coal, as distinct from contractual arrangements that flow from other factors, or what might arguably be other factors, that raises an issue.

Well, let me again thank both of you for your testimony. As I indicated, we will leave the record open for two weeks. We will also be submitting further questions in writing that will give you a chance to more fully develop the record. And I want to thank you very, very much for your participation here, as well as the other witnesses. I think we have had a productive hearing.

[Whereupon, at 12:24 p.m., the hearing adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

RESPONSES FROM THE DEPARTMENT OF THE INTERIOR

QUESTIONS FROM SENATOR MELCHER

Hearing on Coal Royalty Product Valuation, November 16, 1987

1. Question: I wrote to Secretary Hodel last spring to voice my strong concern about the MMS proposed coal product valuation rules. One of the issues I was concerned about was "take-or-pay". Under the proposed MMS rules, so called "take-or-pay" payments would be included in the "value of coal" for royalty purposes.

   ° What is the rationale for including these payments?

   ° How will MMS ensure that the lessee is not charged additional royalties when the coal is actually produced?

   Answer: The collection of royalty has always been based on the total value of coal removed or sold from the lease. In this respect, the Minerals Management Service's (MMS) policy of collecting royalties on "take-or-pay" payments is not a departure from existing coal royalty valuation policy.

   "Take-or-pay" payments received under a contract for the sale of coal subject to a "value" lease are a part of the total consideration or value paid for the purchase of coal under the contract. The purchaser is willing to incur this obligation to obtain a steady and adequate supply or inventory. The lessee/producer is ensured a continued minimum revenue stream to meet the ongoing costs of its production operations. (In the absence of the take-or-pay obligation, the producer would have insisted on a higher per-unit purchase price.) Because revenue paid under a take-or-pay clause is part of the total consideration paid for the purchase of the product, it is part of the "gross value" of the product under 30 CFR § 203.200(f).

   The MMS does not envision any circumstances where lessees will pay royalties twice for the same coal. When the coal purchaser "makes-up" the "take-or-pay" payment, no royalty is due until the dollar value of the take-or-pay royalty payment is recouped. The MMS emphasizes that it is the dollar value of the payment which is recouped, not the tonnage of coal involved. The royalty payments will continue to offset against the credit until the sum of these royalty payments reported is equal to the take-or-pay royalty payment. After that time, the lessee must commence payment of royalty due.

   There may be situations in which a purchaser pays money to a lessee which is not part of the product purchase price nor paid under clauses having characteristics discussed above nor paid as a "reimbursement" of other costs which is part of total consideration. Payments which are unrelated to the total consideration for and value of production are not royalty-bearing.

For example, payments received by lessees covering contract severance damage which are unrelated to the take-or-pay obligation would not be considered as gross proceeds and no royalties would be due thereon.

2. Question: Governor Schwinden of my home state of Montana has written to you indicating that black lung and abandoned mine land fees should be included in gross proceeds for the purposes of coal royalties. The proposed MMS rules would exclude these fees.

   ° Why?

   Answer: The Federal Black Lung Excise Tax and the Abandoned Mine Land Reclamation Fee are the only Federally imposed taxes on coal production. We do not consider it appropriate for the Federal Government to assess a Federal royalty on a Federal tax. Secondly, we consider any increase in royalties resulting from inclusion of these taxes as inequitable because many of the existing Federal leases were in existence prior to 1977, when both of these taxes were enacted.

3. Question: According to MMS estimates, adoption of the proposed rules will result in a decrease in Federal royalty receipts averaging $13 million per annum for production from the six major Western coal producing states. However, some industry officials reportedly charge that adoption of the proposed rules could cost industry $100 million.

   ° How do you account for this discrepancy?

   Answer: The MMS's August 27, 1987, Royalty Impact Analysis estimates a $13 million decrease in Federal royalty receipts for 1990, based on internal forecasts of coal prices and production levels. For Calendar Year 1988, where coal prices and tonnages are more accurate and reliable, MMS estimates that total royalty revenue from Federal coal leases would decline about $11.7 million if reimbursements for the Black Lung Excise Tax and the Abandoned Mine Land Fee were excluded from the value for royalty purposes. The estimated $11.7 million royalty revenue decline represents a reduction of about 5.9 percent of estimated Calendar Year 1988 Federal coal royalty receipts.

   The MMS cannot substantiate industry's assertion that the proposed rules could cost Federal coal lessees $100 million. However, based on numerous comments received by MMS to date, the $100 million cost may be the result of the Federal coal lease royalty rate readjustment process and not the proposed valuation rulemaking. There are 522 Federal coal leases of which 125 are producing. Of these 125 producing leases, 98, or 78.4 percent have had their royalty rates readjusted. These account for 56.2 percent of the coal produced on Federal leases. By November 1989, this production percentage is expected to increase to 80.5 percent because 12 more of the 125 producing leases will have had their royalty rates readjusted. Existing cents-per-ton royalty terms are being replaced by ad valorum royalty rates at the time of readjustment. As this is done, the amount of royalty to be paid in the future will substantially increase. The readjustment process, however, is required by the Federal Coal Leasing Amendments Act of 1976.

4. Question: Under existing rules, are federal royalties paid on:

   ° Take-or-pay payments?

   ° State severance taxes?

   ° Reimbursements for AML fees?

   ° Reimbursements for the Federal black lung tax?

   ° Reimbursements for Federal royalty payments?

   ° Processing costs?

   ° Transportation costs?

   Answer: Existing rules require lessees to report the full value received for the sale of Federal and Indian coal, including any reimbursements or other payments. This, therefore, would include reimbursements to the lessee for state severance taxes, AML fees, Federal black lung tax, and Federal royalty payments. Under the proposed rules, MMS would eliminate AML and black lung taxes from royalty computations.

   Royalties are also due on take-or-pay payments, if they are part of the total consideration or value paid for the coal. For further discussion see our answer to question #1.

   With respect to processing and transportation costs, MMS allows deductions from royalty payments for the actual reasonable costs incurred to wash Federal coal, which improves its quality, and for transporting coal to points of sale distant from the mine.

5. Question: The proposed rules would require royalties to be charged and paid on gross proceeds accruing or which could accrue to the lessee, unless the lessee pursues contract enforcement using reasonable, documented measures to force contract compliance.

   ° Does this mean that in some instances where the lessee does not receive payment, royalties will be charged anyway?

   ° Doesn't this get MMS in the business of second-guessing day-to-day marketing decisions of the lessees in instances where contracts are modified?

   ° Isn't this administratively cumbersome?

   Answer: The January 1987 MMS proposed rule would establish a firm policy which would declare gross proceeds derived from a freely negotiated arm's-length contract as value for royalty purposes. This policy would be applied to all Federal leases and Indian coal leases and would affirm the concept that values embodied in freely negotiated contracts establish equitable values for royalty purposes. With such weight assigned to the sales contract, it is not considered unreasonable for MMS to expect lessees to make good business decisions for the benefit of the Federal and Indian lessor, as well as for itself. If a lessee, for any reason, fails to make proper and timely application for payments or reimbursements to which it is entitled, MMS will see that the Federal or Indian lessor shall not suffer a loss and will bill royalty due with late payment charges, if an interest assessment is appropriate.

The MMS is aware of the litigation risks faced by a lessee trying to obtain a higher price or benefit to which it is entitled to under its sales contract. Hence, under the proposed rules MMS would consider action taken by the lessee to obtain receipt of revenue as evidence of prudent action. Therefore, when a lessee does make proper and timely application for payments or reimbursements to which it is entitled, royalties will not be due until the lessee receives payment.

The MMS does not consider the process of assuring proper royalty payment to be administratively cumbersome.

6. Question: Please compare the treatment of transportation costs under the joint industry proposal using the IRS depletion base and under the MMS proposed rules.

Answer: Under MMS's proposed rules the lessee may deduct coal transportation allowances without prior MMS approval so long as the allowance does not exceed 50 percent of the value of the coal transported or the combined amounts of the coal transportation and coal washing allowance deductions does not exceed 75 percent of the value of coal washed and transported to a remote point of sale. Allowances in excess of these limits may be granted but require prior MMS approval. No transportation allowance would be permitted that would reduce royalty payments to zero.

Under the joint industry proposal the cost of transportation to points of sale or to processing plants not in excess of 50 miles from the mine would be included as "gross royalty value" and then excluded from value by deducting the "processing allowance" (see below). In those instances where long-distance transportation costs are included in the selling price, those costs would be removed from "gross royalty value" before the "processing allowance" is deducted.

The principal difference between the MMS and the joint industry proposal is that transportation at the mine--subsequent to crushing and sizing, but prior to sale--is an allowable deduction under the joint industry proposal; i.e., included in the processing allowance. This transportation is considered a mining cost under the MMS proposed rules, and thus not deductible from Federal and Indian royalties.

7. Question: Please compare the treatment of processing costs under the joint industry proposal and under the MMS proposed rules.

Answer: The MMS proposed rules would allow the lessee to deduct coal washing allowances without prior MMS approval as long as the coal washing allowance does not exceed 50 percent of the value of washed coal, or the combined amounts of the coal washing and transportation allowances does not exceed 75 percent of the value of washed coal at the point of sale. Allowances in excess of these limits may be granted but require prior MMS approval. No allowance would be permitted that would reduce royalty payments to zero. Lessees would advise MMS of their intent to deduct a washing allowance using a designated form. Detailed allowance calculation procedures are included in the proposed rules in order to provide certainty to lessees.

The joint industry proposal provides for a "processing allowance" which would be deducted without prior approval. There is no approval threshold. The "processing allowance" includes amounts generated by any processes or handling that occurs after the coal has been extracted, crushed, and sized. A form of a "proportion of profits' formula would be applied as follows:

$$\text{Gross Royalty Value x } \frac{\text{Post Marketable Condition Costs}}{\text{Total Pre and Post Marketable Condition Costs}} = \text{Processing Allowance}$$

The proportion of profits formula permits recovery of all costs incurred after extraction, crushing, and sizing a portion of any value added by those costs.

The principal differences between the MMS and joint industry proposals are: 1) the MMS proposal would allow deduction of reasonable actual costs, while the joint industry proposal uses a "proportion of profits" method; 2) handling, storing, and local transportation expenses incurred subsequent to crushing and screening are deductible in the joint industry proposal, while these expenses are considered mining costs in the MMS proposal, and thus not deductible from Federal and Indian royalties.

QUESTIONS FROM SENATOR CONRAD

Question: Under the MMS proposed rules, at what point would value for royalty purposes be assessed?

- How does this differ from the joint industry alternative?

Answer: Under the MMS proposed rules the point at which value for royalty purposes is to be determined is at the mine. Usually this is f.o.b. railcar at the mine load-out facility, the customary point of sale and point of shipment to market in the coal mining industry.

In order to provide accountability for the coal disposition and an audit trail, the MMS royalty reporting procedures require the lessee to report the gross proceeds at the point of sale even though that sale may be distant from the mine. For instance, if coal is sold f.o.b. destination, and the sale proceeds includes transportation, a transportation allowance would be reported separately and deducted from the gross proceeds amount in order to ensure royalty payments that are f.o.b. mine.

If the coal is washed prior to sale, the same reporting requirements would apply except that a washing allowance would be reported separately and deducted from the royalty payment as an additional deduction.

The lessee is required by lease and regulation to place coal in marketable condition at no cost to the lessor. If, by agreement, the purchaser is providing certain services which are normally a part of the lessee's responsibility to place coal in marketable condition, then the gross proceeds would be increased by the amount of the value of the services being provided.

The joint industry alternative proposal and MMS proposed rules are similar in that they both begin with the gross value as the basis for value for royalty purposes. That value is then adjusted in both methods. However, the joint industry alternative differs in two areas.

The first variance is that for f.o.b. destination sales, out-bound transportation costs from the mine to the point of sale are deducted to arrive at the "gross income from property." The industry proposal would therefore begin with a base value which is net of out-bound transportation costs. The deducted out-bound transportation costs would not be documented in royalty reports submitted to MMS.

The second variance is that a new definition of "marketable condition" would be adopted. The industry-proposed point where coal would be deemed to be in marketable condition would be that point at which the coal has been crushed and sized to contract specifications. Mining costs occurring after that point, such as handling, storing, stockpiling, blending, and loading into railcars would be deducted as a "processing allowance" from the "gross income from property" to arrive at a "net income from property." Royalty payments would then be valued based on the "net income from the property." The industry alternative proposal would therefore move the MMS proposed point of value assessment from the customary point of sale and shipment to market to a point in the mining operation.

The joint industry alternative proposal would virtually eliminate the standard reporting and allowance computations prescribed by the MMS proposed rules to provide accountability and an audit trail to the Federal and Indian lessors.

2. Question: What steps does MMS intend to take to ensure that contracts are "arm's-length" under the MMS proposed rules?

   Answer: Under the proposed rules the lessee has first responsibility for determining the arm's-length nature of its contract. The MMS proposed rules also provide that the lessee may be required to certify as to the arm's-length nature of their coal sales. The lessee's determination of the nature of the contract is subject to future audit to verify that the contract meets the proposed rules' criteria for arm's-length contracts. In questionable circumstances, the proposed rules allow MMS to require the lessee to submit sales contracts upon request and to designate for each contract submitted whether the contract is arm's-length or non-arm's-length.

3. Question: Has the Department prepared any type of legal analysis or summary of the coal depletion provisions of Section 613 of the Internal Revenue Code and related regulations? Has the Department received any such analysis from the IRS?

   - If so, please provide copies for the record.

   Answer: The Department has not undertaken any legal analysis of Section 613 of the Internal Revenue Code (IRC) and related regulations. The MMS did meet with IRS personnel on September 9, 1987, to discuss IRC Section 613 and its potential as a means to value coal for royalty purposes. The MMS has also requested, by letter dated September 14, 1987, that the IRS provide written comments concerning adapting IRC Section 613 to the valuation of Federal and Indian coal for royalty purposes. The IRS notified MMS by letter dated October 28, 1987, that the National Office would respond. No response from IRS has yet been received.

4. Question: Do you have any further suggestions for the record on how to address the problems relating to valuation of lignite for federal royalty purposes?

   Answer: Governor Sinner of North Dakota has informed us of his concern that our proposed royalty valuation methodology might not be applicable to North Dakota lignite. He stated that virtually all of North Dakota's lignite production is sold under long-term contracts on a cost-plus basis, thus making it difficult to arrive at an independent determination of market value. He also mentioned that North Dakota lignite is associated with high mining costs which result in larger royalties without regard, in his opinion, to the true value of the coal.

The Department is actively pursuing any option that may be available for special coal production situations. The Bureau of Land Management is presently conducting a study on coal royalty rates which will consider the possibility of reducing rates in special situations such as lignite mining. This study includes coal mined in the states of Oklahoma, North Dakota, and Alabama. It will be finished in early 1988.

5. Question: Has the Department undertaken any analysis of the royalty rates applicable under newly-negotiated private coal contracts?

° If so, please provide this for the record.

Answer: The Bureau of Land Management has undertaken an analysis of prevailing royalty rates which includes some information on newly-negotiated private coal leases. Their study will not be completed until early 1988 at which time it will be made available to you.

Colorado·Ute
Electric Association, Inc.

P.O. Box 1149
Montrose, Colorado 81402
(303) 249-4501

November 25, 1987

Senator John Melcher, Chairman
Mineral Resources Development and Production
SD-362 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Melcher:

In response to your letter dated November 18, 1987, soliciting responses to additional questions of Subcommittee members relating to the November 16, 1987 oversight hearing on coal royalty product valuation, I am enclosing the responses of Colorado-Ute Electric Association, Inc. Ten additional copies of the responses are enclosed for use of the Subcommittee and Staff.

Thank you for the opportunity to make these further responses. Because of time constraints, Colorado-Ute's responses to the questions are briefer than they might otherwise have been. If you or any other Subcommittee member desire clarification or further information on any of these issues, please let me know.

Very truly yours,

Girts Krumins

Girts Krumins
President

GK:jeh

Enclosures as stated

RESPONSE OF COLORADO-UTE ELECTRIC ASSOCIATION, INC., TO ADDITIONAL QUESTIONS FOR THE RECORD FROM SENATOR MELCHER TO INDUSTRY

Hearing on Coal Royalty Product Valuation
November 16, 1987

(1) Please compare the treatment of transportation costs under the joint industry proposal using the IRS depletion base and under the MMS proposed rules.

Response: Using the IRS depletion point, transportation costs would be entirely excluded from the value base used for royalty calculation, except for certain in-mine and pre-basic processing transportation (generally limited to 50 miles) costs includable in depletable income under IRS regulations. The MMS proposal would allow transportation costs to be deducted from the "gross proceeds" base for royalty collection but would arbitrarily limit the transportation allowance to 50 percent of the value (e.g., sales price) of the transported coal. In cases where transportation costs exceeded 50 percent of the total sales price, the MMS proposal would unfairly collect royalty on the portion of the transportation cost exceeding 50 percent.

(2) Please compare the treatment of processing costs under the joint industry proposal and under the MMS proposed rules.

Response: As with transportation, the MMS proposal would apply restrictive percentage allowances to the amount which may be deducted from the "gross proceeds" value base for processing costs. The joint industry proposal uses a cost driven price allocation method far simpler than that proposed by MMS. The potential for excessive processing deductions is greatly reduced because the industry method is an allocation of price, whereas MMS proposes to calculate the allowance independently of price using a complex and unrealistic formula.

(3) Have you undertaken an analysis of how much the industry proposal will cost the Western States in terms of forgone royalty revenues?

- How much less will they receive than last fiscal year?

Response: Colorado-Ute has not made an extensive analysis of how much the industry proposal would cost the Western States in terms of forgone royalty revenues. Such an analysis would require extensive research and analysis of the price elasticity of demand for federal coal. The question you have posed assumes that royalty revenues will decrease because of the industry proposal. This presupposes that the demand for a Western federal coal is price inelastic -- something we do not know, but suspect is incorrect.

However, it is a fact that in most Western States, much of the 12.5 percent royalty has not yet come into effect pending readjustment of old leases. The question is not how much royalties will decrease, but how much of an increase will occur. Substantial increases in the federal royalty rate may produce actual decreases in royalty revenue as the demand for Western coal decreases. The royalty from a closed mine is zero.

Our focus has been on Colorado, where some 38 coal mines were closed or not producing in the last several years, most of them since 1983.

In Colorado, Governor Romer has recognized that federal coal royalties have increased to the point where Colorado coal, which is relatively expensive to produce, may become uncompetitive because of the MMS cost-based royalty method. In a letter to MMS dated July 23, 1987, commenting on the proposed MMS valuation regulations, Governor Romer stated that Colorado was willing to accept a reduction in royalties from the $20.0 million fiscal 1986 level to the $13.1 million fiscal 1984 level. His letter supported use of the federal depletion point, which would preclude assessment of royalties on severance taxes, fees, and royalty-on-royalty, as proposed by MMS. He stated that the industry proposal would "maximize long-range revenues to the State by increasing the competitiveness of Colorado coal and, perhaps, enhancing the economics of marginal operations".

(4) Would the MMS proposed rules alter existing practice on coal valuation?

- If so, how?

Response: The MMS proposal would alter existing practice on coal valuation by seeking to superimpose on the coal industry methods used for oil and gas royalties which are entirely inappropriate for the coal industry. It would also perpetuate existing practices which Colorado-Ute believes are poorly conceived.

These changes have been addressed in Colorado-Ute's previous comments and testimony regarding the MMS proposal. A copy of my comment letter dated March 26, 1987, is attached.

The joint industry proposal also addresses these changes, and, while it does not cure every problem raised in Colorado-Ute's comment letter, we strongly urge its adoption.

Colorado·Ute
Electric Association, Inc.

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March 26, 1987

Minerals Management Service
Royalty Management Program
Rules and Procedures Branch
Denver Federal Center
Building 85
P. O. Box 25165
Mail Stop 660
Denver, Colorado 80225
Attention: Dennis C. Whitcomb

Dear Sirs:

Comments Regarding Proposed Revision
of Coal Product Valuation Regulations
and Related Topics (52 Fed. Reg. 1840, January 15, 1987)

Colorado-Ute Electric Association, Inc. (Colorado-Ute) submits the comments which follow in response to the proposed regulations governing the valuation of coal for royalty purposes published by the Minerals Management Service ("MMS") on January 15, 1987. Colorado-Ute believes that the proposed regulations perpetuate and aggravate several existing regulatory problems and create several new ones. Unless the proposed rules are revised substantially, they will have a very serious negative impact not only upon Colorado-Ute and Colorado-Ute's electric consumers (who must foot the bill for federal coal royalties as a "hidden tax") but also on the viability of Colorado's ailing coal industry, which would be forced to bear the burden of some of the highest federal royalties (on a per ton basis) in the entire nation. It is, we believe, a burden that the Colorado coal industry and Colorado-Ute's consumers cannot bear.

Colorado-Ute is a rural electric generation and transmission cooperative which serves, on a not-for-profit basis, the wholesale power needs of its fourteen member/owner distribution cooperatives, which serve nearly 200,000 customers (representing a population of about 600,000) located in Western, Southern, and Central Colorado. Colorado-Ute generates most of the energy it delivers to its customers at large mine-mouth coal-fired generating plants, the fuel requirements of which are supplied under long-term contracts for coal, much of which is mined from nearby federal leases. The decisions made by Colorado-Ute and other coal purchasers many years ago to enter into such long-term contracts, and the construction of base load coal fired plants to consume the coal, made the development of federal coal in Colorado possible. As a result the federal government has received millions of dollars in coal royalties under older leases issued with a cents per ton royalty rate, and a coal mining industry developed in Colorado which is very important to the state's economy.

Now, however, we find that the efforts of the MMS and the Bureau of Land Management ("BLM") to impose a 12 1/2 percent royalty rate, and to impose it on a calculated value inflated by other government fees and taxes, and even the royalty itself, threaten to increase the cost of Colorado coal to the point where it would be more economic to cease purchases from the mines mining federal coal just a few miles away from our plants and to instead purchase either state or private coal with a reasonable royalty or to bring in lower priced coal from another region, with a lower royalty per ton, even though transportation costs would increase drastically. Other buyers of federal coal may find it more economic to purchase foreign coal. In one pending case, imposition of the 12 1/2 percent rate, if upheld, would increase the coal royalty paid by Colorado-Ute and its consumers by nearly 2,000 percent. Total federal royalty cost increases faced by Colorado-Ute could exceed $7 million per year by 1989 - and Colorado-Ute is concerned that the potential bill could go even higher under the proposed regulations.

The simple facts are that the BLM and MMS treatment of royalties for federal coal leases in Colorado threatens to end the mining of those leases and to produce unwarranted cost increases for the farmers, ranchers, small businesses, homeowners and other customers of Colorado-Ute and its members - who can ill afford it. A cure for these problems can only be effected if the federal government takes a more realistic approach to coal royalty regulation. Otherwise, the MMS may find that it has killed the golden goose, because its royalty will suddenly amount to 12 1/2 percent of ZERO, since that will eventually be the amount of Colorado coal which will be sold under these punitive regulations.

1. The Royalty Rate.

The first and foremost problem is the perpetuation of the application of the 12 1/2 percent royalty to pre-1976 leases. The coal mines entered into these leases, and Colorado-Ute entered into long-term contracts with royalty pass throughs, with the expectation that the periodic royalty increases allowed under the leases would bear some degree of reasonableness. Now, simply because Colorado coal is among the most capital intensive and expensive to mine of all federal reserves, the arbitrary application of a percent of value royalty (instead of a set amount per ton) is producing royalty increases routinely exceeding 1000 percent, and in the case of one Colorado-Ute supplier reaching nearly 2000 percent. Colorado-Ute is of course hopeful that the FMC Wyoming Corp. decision will be upheld - but in any event firmly believes that the federal government will ultimately have to abandon its current policies or force the ruination of much of the western coal industry.

2. The "gross proceeds" definition.

The basic problem caused by the assessment of a 12 1/2 percent royalty is aggravated by the inclusion of severance taxes, other fees, and the royalty itself in the value base upon which the royalty is calculated. The royalty should only be applicable to the intrinsic value of the coal as mined, and not to governmental fees and taxes which add nothing to the value of the coal, although they may cause substantial costs.

The MMS proposal to exclude SMCRA and black lung fees from gross proceeds is a step in the right direction. State severance taxes, other fees and taxes, and the royalty-on-royalty must also be excluded to limit the royalty to 12 1/2 percent of value, as required by FCLAA.

3. The definition of "arm's-length contract".

The definition of an arm's-length contract is unduly restrictive in excluding any contract in which there is currently any ownership interest (regardless of how small) running between the parties to the contract. The definition should include all contracts which qualified at their inception, and which have not been substantially amended. Otherwise, coal customers such as Colorado-Ute, which have purchased an interest in a previously unrelated supplier long after the contract was negotiated, would be arbitrarily disqualified from using the contract price as the measure of coal value, and be placed at risk that MMS may instead impose a coal value for royalty purposes which exceeds both the value established under the existing arm's-length contract, and the fair market value of the coal.

Colorado-Ute and the three other participants in Craig Station Units 1 and 2 (two 400 mw coal-fired generating units located near Craig, Colorado) contracted in 1973 with Utah International, Inc. for a long-term coal supply for these units from an adjacent mine. The parties to the contract clearly met the requirement of the proposed "arm's-length contract" definition that they be independent non-affiliated persons.

Subsequently, however, the four coal purchasers, through subsidiaries, formed a new company, Trapper Mining, Inc., which purchased the mine from Utah International. Colorado-Ute and the other coal purchasers have not attempted to revise the pre-existing arm's-length contract. In fact, they have consciously and carefully preserved the arm's-length nature of the contact so that it can withstand any reasonable regulatory scrutiny. Now, those efforts may be undone unless MMS revises these regulations so that an "arm's-length contract" is determined according to the status of the original parties to the contract. We are concerned that MMS may choose to value the Trapper Mine coal based on another "arm's-length contract" for coal also delivered to Craig Station, which is currently priced far above both the Trapper Mine price and the average market price for other coal in the area. If the parties to the original contract were completely independent and the contract has not been altered significantly, a subsequent acquisition, such as described above, should not change that determination. Colorado-Ute urges MMS to clarify the regulations accordingly.

Colorado-Ute believes that the use of an "arm's-length contract" price as the sole determinant of value will also lead to overpayment of royalties in the case of contracts where the price has escalated above fair market value. Colorado-Ute has one long-term contract, negotiated after OPEC triggered the mid '70's explosion in energy prices and during the period of federal coal leasing moratoriums, which has escalated prices to the point where it results in a price $10 or more per ton over current spot coal prices in the same area, and in fact from the same mine.

In such instances, the electric consumers are being forced to pay too much twice; first on the coal itself, and second on the federal royalty based on the over-inflated price of that coal. Colorado-Ute urges that, in cases where it can be shown that the current "arm's-length" price exceeds the average price for coal sold in the same geographic area by 20 percent or more, the federal royalty should be based on the average price, not the contract price. If such a procedure is not allowed, it will put coal purchasers in such situations under further pressure to find some way to avoid those coal purchases and instead purchase other coal without such a double penalty.

4. Take-or-pay payments.

Colorado-Ute strongly objects to the proposed inclusion of take-or-pay payments or other similar payments in the gross proceeds definition when no coal is actually being produced or removed from the lease. Take-or-pay payments and the like do not represent a payment for the coal itself, but to the coal miner to assure a measure of protection from the burden of fixed costs in the event of a loss of production. The coal itself remains in the ground, and should be subject to a royalty only when and it is actually mined and delivered. Colorado-Ute finds it preposterous that Colorado-Ute and its customers, who made the federal lease development possible in the first place, could be forced to pay the federal government for a "value" for coal Colorado-Ute may never receive. The federal government has no legal or equitable claim to royalties for unproduced coal.

5. Transportation allowance.

The proposed regulations limit the allowance for coal transportation costs to 50% of the value of the transported coal, and further restrict the allowance to transportation to a sales point remote form the lease or mine. Colorado-Ute urges that the final regulations be amended to provide an allowance for all actual transportation costs, regardless of the percentage of value, and to allow costs for transportation of one mile or more to be deducted.

Colorado-Ute is not only interested in these regulations as a consumer of coal, but also as a potential producer of federal coal. Colorado-Ute holds, through a subsidiary, a partnership interest in a federal coal leasehold and mine. The partnership has been actively seeking customers for the mine, so that full production can commence. One area for potential sales is to foreign customers in the Pacific Rim. However, the proposed 50% limit could seriously inhibit such sales. It is quite possible that transportation and related costs could constitute two thirds or more of the sales price delivered on board ship to a foreign customer. Imposition of a royalty on the portion of those costs over 50% of the delivered price would not be justified in the first instance based on the intrinsic value of the coal; but moreover, may result in an uncompetitive price, resulting in lost sales, ZERO royalty, and a lost contribution to alleviating our trade imbalance. This will occur while at the same time current federal coal customers abandon their royalty-inflated contracts for less expensive foreign coal.

In addition, the restriction of the transportation allowance to "remote" sales points only should be revised by defining "remote" as any haul of one mile or more from the actual mine location. It makes no sense to forbid a transportation allowance for sales to the "mine-mouth" customers who enabled the federal lease to be developed in the first place, but allow it for other customers just a few more miles down the road or railroad. Many such "mine-mouth" operations incur substantial transportation costs, which add nothing to the intrinsic value of the coal (coal which in fact may have had virtually no value but for that "mine-mouth" customer). A full deduction should be allowed for these costs.

6. Contract enforcement.

The proposed rules would require payment of royalty based on "the highest price a prudent operator could receive under its contract" (§ 206.259(e)). It appears that MMS intends to require coal miners to assess the highest possible price under their contracts, and if they fail to do so, to assess the full amount of royalty on any uncollected increase.

This proposal ignores the realities of the marketplace and of how coal contracts are administered. In the first instance, a prudent operator may choose not to impose every price increase which may be available to him simply because those increases may price his coal at a level exceeding fair market value and would cause him to lose sales. Second, it is a rare coal contract indeed where the seller and buyer agree on the meaning of every contract provision affecting the coal price. Disagreements over those provisions are usually resolved in an informal give-and-take process, as is normal in the business world.

The proposed regulation would place MMS in the position of second-guessing the administration of coal contracts, and may spell the end to the amicable informal dispute resolution process, as buyers and sellers are forced to resort to enforcement actions to assure that MMS cannot question the royalty amount. Colorado-Ute urges MMS to take a more reasonable approach which will allow coal operators the flexibility to price their coal in accordance with market conditions, and with the normal mode of contract administration.

7. Payment of Royalty in kind.

The proposed regulations emphasize that the intent is to "assure maximum, long-term revenues to all parties concerned", by allowing the "interaction of competing market forces". It is also apparent that MMS is attempting to overlay oil and gas procedures into the coal regulations, despite the vast differences between the coal industry and the oil and gas industry.

Colorado-Ute believes that the proposed regulations will not assure maximum, long-term revenues to all parties. Instead, they will cause such increased costs to the western coal industry that many coal mines will be forced to curtail operations or close down completely, in which case the revenues to all parties will be ZERO.

If MMS is intent on both assuring that it receives a fair royalty and on imposing oil and gas procedures onto the coal industry, Colorado-Ute believes that it should be willing (and the regulations should give the producer the option) to accept payment of coal royalties, at whatever rate is finally determined appropriate, in kind, as is commonly done in the oil and gas industry. MMS could then be assured of receiving fair market value royalties, by selling the coal itself at the best price it can command in the market. MMS will not be placed in the inappropriate position of coal contract overseer and second-guesser. Coal producers, their customers, and the rural electric consumers of Colorado-Ute would be assured that they did not have to pay royalties increased by MMS regulations to artificially high levels.

Colorado-Ute suggests that if the MMS is truly interested in achieving long-term maximum revenues to all parties, instead of attempting only to maximize federal royalties, regardless of the damage it causes the coal industry, it should be willing to allow optional payment of royalties in kind.

Conclusion

Colorado-Ute believes that the current proposed regulations would be disastrous for the coal industry, particularly the Colorado coal industry and its customers, and the electric consumers who must foot the bill. MMS should draft new proposals which will allow a healthy western coal industry to survive and not unduly penalize the utilities and their customers who made development of federal coal and consequent royalties possible in the first instance.

Very truly yours,

Girts Krumins
President

GK:cdg

RESPONSE OF COLORADO-UTE ELECTRIC ASSOCIATION, INC., TO ADDITIONAL QUESTION FOR RECORD FROM SENATOR CONRAD FOR INDUSTRY

Hearing on Coal Royalty Product Valuation
November 16, 1987

(1) Question: What differences, if any, between the oil and gas and coal industries do you think argue for different valuation methods for these minerals?

Answer: The differences between the oil and gas industry and the coal industry are so great as to fairly compel the conclusion that different valuation methods as well as different royalty methods should be used for the two industries.

As was pointed out in the Report of the Commission on Fair Market Value Policy for Federal Coal Leasing (the Linowes Commission Report) in 1984:

> "It appears that the Congress may have set the 12.5-percent minimum royalty [for coal] without extensive economic analysis. Indeed, it seems more than coincidence that the minimum Federal royalty for oil and gas has long been 12.5 percent. However, the Commission heard testimony that there are large differences between the coal business and the oil and gas business."

The Linowes Commission's Report also found that certain laws affecting coal leasing "appear ... to have been based on assumptions that the Commission heard questioned" (p. 287). The Report recited a portion of the testimony of Steven P. Quarles, congressional staff member involved in drafting the 1970's coal leasing laws, which after first noting that oil and gas was the focus for the committees responsible for coal-related laws, stated as follows:

> "The result is several coal or coal-related statutes which contain concepts and provisions lifted whole from oil and gas law without thorough consideration of their applicability and with an apparent assumption that competition is as easily arrived at in coal leasing as it is in oil and gas leasing. Consequently, the coal statutes speak a good deal about competition, but provide little that is concrete by way of standards and procedures for enhancing competition. Worse, the statutes contain significant real or potential constraints on competition, the competition dampening effects of which Congress did not fully appreciate -- such constraints as minimum royalties, diligence, and surface owner consent requirements" (emphasis added). (id.)

Some of the many differences between the two industries can be summarized as follows:

In the oil and gas industry, the primary cost to the well developer is the initial investment in drilling the well. If the we~~ll~~ is successful, the continuing cost of extracting the oil or gas is minimal.

The price of oil and gas is market driven, and subject to major variations up and down. The royalty due to the lessor goes up and down along with the market. The 12.5 percent royalty, which has been the standard for both federal and private leases for many years, can be paid in kind or in dollars at the option of the lessee.

The value of an individual oil and gas well is directly related to the cost of production. If the current market price is higher than the cost of production, the well is called upon to produce. If not, it will be shut in.

By contrast, most federal coal is in the West, with large mining operations. When a coal mine is developed in the West, it is already known that the coal is there. The cost of developing a coal mine precludes anything in the nature of "wildcatting".

Because a major coal mine may cost $100 million or more to develop, coal lessees normally do not invest such capital unless and until they obtain long-term purchase contracts, primarily with electric utilities. These contracts, and not the market, generally control the price of the coal produced.

In addition to the large initial capital investment required for coal mines, the costs of production comprise a very large percent of the total price of the coal. This is particularly true in Colorado, where Colorado-Ute obtains all of its coal, because of the large amounts of overburden which must be moved to uncover the coal.

Unlike oil and gas, the value of coal is not related to the cost of production. The coal in place does not become more valuable simply because it costs more to mine. If logic were to prevail, that coal should command a lesser royalty (as a percent of cost) than coal which is less expensive to mine. However, the present 12.5 percent coal royalty does exactly the opposite, penalizing purchasers of coal with high production costs, such as the Colorado coal purchased by Colorado-Ute, with some of the highest royalties in the nation.

Also unlike oil and gas, where the 12.5 percent rate was standard for both private and federal leases for many years, the Linowes Commission found that "private royalties were well below 12.5 percent before the passage of FCLAA" (p. 314). However, because the Federal government holds a monopoly position with respect to coal reserves in much of the West, "private royalties have been rising to match the new Federal royalty" since then. (id.)

Lastly, the miner of federal coal is not given the option to deliver a portion of the product, instead of a royalty payment in dollars, as the oil and gas producer has.

Because of the vast differences between coal and oil and gas, the Linowes Commission recommended that the administrative discretion to reduce federal royalties should extend prior to lease bidding, because the 12.5 percent rate could adversely affect resource production.

The requirement that a 12.5 percent royalty be paid on all federal coal leases was cited by Interior Secretary Kleppe as a serious deficiency of FCLAA in a letter to the Senate after President Ford's veto of the bill, and before the veto was overridden. Secretary Kleppe stated as follows:

> "2. The requirement that a minimum royalty of 12 1/2 percent be paid on all Federal coal leases (a) would mean that large acreages which might otherwise be developed may become uneconomic to mine, and (b) may mean higher costs passed on to consumers. This figure is unnecessarily high. Latitude must be preserved to set either lower or higher royalties based on economic conditions and the value of the resource." (See Congressional Record - Senate, August 3, 1976, at 25200.)

His words were true then and remain true.

There are immense differences in the coal industry compared to the oil and gas industry which clearly justify different valuation methods, and different royalty methods.

EDISON ELECTRIC
INSTITUTE The association of electric companies

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December 14, 1987

The Honorable John Melcher
Chairman
Subcommittee on Mineral Resources
Development and Production
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510-6150

Dear Mr. Chairman:

I am writing in response to your November 18, 1987 letter requesting answers to additional questions from members of the Subcommittee on Mineral Resources Development and Production relating to the November 16, 1987 oversight hearing on coal royalty product valuation. Attached is a copy of those questions and answers.

On behalf of the Edison Electric Institute and Northern States Power, I thank you for holding a hearing on this important issue.

Sincerely,

David H. Peterson

David H. Peterson
Director, Fuel Supply
Northern States Power

Enclosures

Hearing on Coal Royalty Product Valuation, November 16, 1987

Questions from Senator Melcher:

(1) Please compare the treatment of transportation costs under the joint industry proposal using the IRS depletion base and under the MMS proposed rules.

Under the joint industry proposal using the IRS depletion-based benchmark as a starting point for the determination of net royalty value, the need for a transportation allowance is eliminated.

The MMS proposed rules allow a 50% deduction as a transportation allowance. The Director of MMS could approve an allowance in excess of the 50% in certain cases.

(2) Please compare the treatment of processing costs under the joint industry proposal and under the MMS proposed rules.

The joint industry alternative utilizes an apportionment method of calculating a processing deduction which has many advantages over the MMS proposed approach. The joint industry calculation is simple and easily audited and is used by other federal and state agencies. The MMS proposal provides for limitations on processing in an attempt to curtail excessive deductions. The potential for excessive deductions would be eliminated using the joint-industry proposal because the calculation is based upon the selling price rather than an unrelated basis as proposed by the MMS.

(3) Have you undertaken an analysis of how much the industry proposal will cost the western states in terms of forgone royalty revenues? How much less will they receive than last fiscal year?

During the Hearing, Don Coovert and Martin White, representing the National Coal Association, submitted a detailed comparative analysis of the fiscal effects of both the MMS and industry proposals. This report was entitled "Federal Coal Royalty Valuation, Comparative Impact Analysis of Minerals Management Service Valuation Proposal and Joint Coal/Utility Industry Valuation Proposal." Electric Utilities participated in the development of some of those calculations and numbers and we subscribe generally to the conclusions therein. We did not attempt to calculate how much fuel switching would take place. Nor have we tried to calculate whether coal demand would be stimulated or reduced from federal lands given different regulatory scenarios for product valuation.

It should be noted that the annual royalty has increased substantially since the implementation of FCLAA. In the FCLAA legislative history, the Council of Economic Priorities reported that the federal government collected $23 million in royalty payments during the first 54 years after the enactment of Mineral Lands Leasing Act of 1920. This was on total production of 189 million tons of coal. More royalties are now collected in one year than were collected during that entire time frame. This amount includes both the federal and state portions.

(4) Would the MMS proposed rules alter existing practice on coal valuation? If so, how?

The proposed rule would create considerable revision in existing coal royalty valuation. The proposal does not consolidate or streamline existing rules. In fact, it is an unwarranted and complex regulatory scheme which appears to require a very large auditing staff which may or may not be appropriately trained to undertake such auditing functions.

The Reagan Administration has made clean coal technology development a priority. But the MMS proposal, through its attempt to calculate a royalty on the capital investment made in coal processing, liquefaction or gasification seeks a royalty on these capital investments. We believe that this would significantly deter the development of capital investment in clean coal technologies.

Some aspects of the proposal go beyond incorporating current practice. Current regulations do not have a washing and transportation allowance limit. The MMS proposal would place limits on these.

The MMS proposed rule would assess royalties on "take-or-pay" payments as part of "gross proceeds" for royalty valuation purposes even though the coal is still in the ground. Currently, coal royalties are paid on the value of coal severed and produced, and not on damages, remedial provisions, options or other devises resulting in cash flow under a sales contract for coal that is not produced.

The MMS proposal would allow MMS to administratively set the price for coal if it does not feel that there was an "arms-length" contract between two parties. In fact, the way in which the definitions of an arms-length contract are drawn is such that if a utility pension fund owned one share of stock in a coal company, the coal procurement function would be deemed as non arms-length, and the price subject to determination by the MMS. This is an unwarranted expansion of MMS power that could place MMS at meetings between vendors and purchasers.

The above examples are some of the many instances where the proposed rule deviates from the law as well as current DOI regulations and practices. The proposal simply does not constitute "consolidation," "streamlining" or "clarification" as MMS contends. It is a massive re-write of current law and DOI rules and practices.

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December 14, 1987

The Honorable Kent Conrad
Subcommittee on Mineral Resources
  Development and Production
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Senator Conrad:

I am writing to you concerning the oversight hearing on coal royalty product valuation before the Subcommittee on Mineral Resources Development and Production on November 16, 1987. Enclosed is my response to your additional question for the Record, along with my answers to questions submitted by Chairman Melcher.

We appreciate your interest and leadership on this important issue.

Sincerely,

David H. Peterson

David H. Peterson
Director, Fuel Supply
Northern States Power

Enclosures

Hearing on Coal Royalty Product Valuation, November 16, 1987

Question from Senator Conrad:

(1) **What difference, if any, between the oil and gas and coal industries do you think argue for different valuation methods for these minerals?**

There are a number of differences among coal, oil, and gas which argue for different valuation methods. The method by which these minerals are transported is one example. Oil generally moves directly from the producing wells to a refinery either in a pipeline or in a tanker, and the refiner that receives the oil is neither the final user nor the final destination of the products made from the crude. Coal on the other hand generally goes from the mine to a tipple (loading point) to be shipped by trucks, trains, or pipelines to its final destination (i.e., the utility that will consume the coal).

The marketing of coal and oil is entirely different. Domestic oil producers' prices can be hostage to the production and price quotas established by OPEC. Oil is sold via a posted or market price (usually a New York Harbor price) while the majority of coal is sold via a long term contract agreed upon through negotiation between the producer and buyer and is not subject to as many market influences. Commodity markets exist for natural gas and oil, but due to the structural differences in coal as a commodity (sulfur, ash, moisture, heating value, and trace mineral contents) a commodity market does not now exist for coal as it does for the other fossil fuels.

Also, the cost of production of these fuels differs greatly. The capital investment in oil or natural gas production while large, is very small considered next to the capital investment required to open a coal mine. Oil and gas production can continue on a routine basis with little manpower requirements, whereas the requirements of a coal mine are large. Unlike oil and gas, coal mine production operations require considerable maintenance of very heavy and expensive equipment which must be maintained to keep an operation sustained. Without regular use and mining operations, capital investments in a coal mine would have to be replaced before they could be used again. In terms of resource extraction, the presence of natural gas and oil in produceable quantities is always more uncertain than coal reserves.

THE NAVAJO NATION
PETER MacDONALD, CHAIRMAN
THE NAVAJO TRIBAL COUNCIL
JOHNNY R. THOMPSON, VICE CHAIRMAN
THE NAVAJO TRIBAL COUNCIL

November 30, 1987

Senator John Melcher, Chairman
Senate Subcommittee on Mineral Resources
Development and Production
Washington, D.C. 20510-6150

RE: Coal Royalty Product Valuation

Dear Senator Melcher:

Thank you for your letter of November 18, 1987 requesting additional information on coal royalty product valuation. The Navajo Nation submits the following in response to your questions.

(1) What impact do you anticipate the proposed rules to have on your royalty revenues?

We are unable at this time to provide a definitive analysis of the economic impact of the proposed regulations; however, the agency best situated and most appropriate to provide the information requested, consistent with the trust obligation owed to Indian tribes, is the MMS. We would reiterate here our request that MMS provide both you and us with the economic analysis you are requesting.

The Navajo Nation Minerals Department has, however, prepared estimates of the impact of omission of the Abandoned Mine Lands Fees and the Black Lung Tax from the gross proceeds upon which coal royalties are based. The economic loss to the Navajo Nation would be approximately $2.1 million annually. This figure is based on production estimates from four out of our five leases and on the current reclamation fee of $.35/ton and the current Black Lung Tax of $.55/ton. Our losses will increase if our remaining coal lease goes into development.

In addition, these losses will escalate proportionate to any future increases in the existing fees and taxes. As an example, in early 1987, President Reagan proposed a 54% increase in the Black Lung Tax to $.85/ton. Such an increase in the Black Lung Tax translates into an additional loss of $850,000 in royalty revenues.

Additional losses attributable to the impacts from the balance of the proposed regulations will, in our view, result in significant reduction in coal royalty revenues, especially if the proposed allowances for washing and transportation are adopted. It is most appropriate for MMS to provide the estimates of impacts of these regulations since it is the agency proposing the changes and since this information should be in its possession before the regulations are adopted.

Post Office Box 308 ● Window Rock, Navajo Nation (ARIZONA) ● (602) 871-4941

o What impact would the joint industry proposal have on your royalty revenues?

We are unable to estimate the total losses in coal royalty revenues that would be attributable to regulations based on the Joint Industry Proposal (JIP). This proposal would, however, radically alter the basis upon which royalty is paid. Under the current regulations, royalties are paid on the value of the coal. Value-based regulations are necessary for royalty determination of ad valorem coal leases. The JIP would shift from valuation criteria to an income-based system. Since our lessees do not share their financial information with the Navajo Nation, we do not have sufficient data upon which an estimate can be made of the full impact of the industry proposal on tribal coal revenues.

Moreover, as we indicated in earlier testimony, the entire theoretical framework underlying MMS's value based regulations and IRS's income driven regulations are fundamentally different. IRS has no interest in the "value" of the resource. Basing royalty considerations on IRS income regulations is simply inappropriate to the task of determining resource values.

(2) What effect would adoption of the MMS proposed rules have on the development of the Navajo Nation's coal resources?

Reduction of revenues from royalty will depress the desire to further develop our most abundant resources. It will also increase the pressure to shift the economic burden to taxation and other revenue sources to compensate for lost royalties.

The recently renegotiated coal agreements on Navajo all were based to some degree on the existing royalty formula. Those agreements, incorporating the formula, were then submitted to the Secretary of the Interior for ratification. That same Secretary, through the agency of the MMS, is now proposing to change the very rules upon which those leases were approved by him. While it may not be the case that a different royalty rate would have been agreed to, some alternative economic benefit may very well have been extracted.

o What effect would adoption of the joint industry proposal have?

The JIP is based upon a radically different valuation approach that does not focus on the value of the resource. Adoption of this formulation would also have the affect of depressing the interest in further development of the Navajo's coal resource. In like manner it would force the Navajo to look to alternative sources of revenue to replace the lost royalties. In some cases, that could mean increased taxes, in others it would require other approaches. In sum, it could be quite disruptive. In any case, it would likely lead to extensive litigation.

CONCLUSION

We wish to make a final point. The proposals presently before MMS include the present regulations, and the MMS proposed changes. We get the impression from some quarters that the "Joint Industry Proposal" (JIP) is viewed as the option to MMS's proposed changes.

The Navajo Nation rejects such a proposition. The questions still remains "Should MMS change its regulations at all?" If so, then there should be careful assessment of the impacts in all quarters. In particular, MMS should provide the Indian Tribes and allottees, and the Congress with a detailed analysis of the impacts of those changes prior to implementation.

Thank you for the opportunity to respond to your questions. We appreciate your concern and dedication to hearing the thoughts of those most impacted by this issue. Please contact us if additional information would be of value.

Sincerely,

Donald R. Wharton

Donald R. Wharton
Assistant Attorney General
Navajo Nation Department of Justice
P.O. Drawer 2010
Window Rock, Arizona
(602) 871-6931

DRW:bmm
cc: Senator Kent Conrad

APPENDIX II

Additional Material Submitted for the Record

State of Montana
Office of the Governor
Helena, Montana 59620
406-444-3111

TED SCHWINDEN
GOVERNOR

November 16, 1987

Honorable John Melcher, Chairman
Subcommittee on Mineral Resource
Development and Production
Committee on Energy and Natural Resources
Washington, D.C. 20810-8150

Dear Senator Melcher:

Attached are comments that I recently sent to Assistant Secretary Griles regarding the Mineral Management Services proposed product valuation regulations for coal. The letter is submitted as testimony for your subcommittee's consideration during its oversight hearings on the Department of Interior's proposed rules relating to the valuation of coal production from Federal and Indian leases for royalty purposes. These comments were sent on behalf of myself and the Governors of Colorado, New Mexico and Wyoming.

I am told that at your committee's oversight hearing yesterday there was confusion expressed by Assistant Secretary Griles regarding western governors' concensus opinion on the coal royalty valuation formula. Please let the hearing record show that for the four governors referenced in my October 6th letter there is concensus on the issues included in the letter.

Sincerely,

TED SCHWINDEN
Governor

Enclosure

cc: The Honorable Garrey Carruthers
The Honorable Roy Romer
The Honorable Mike Sullivan
The Honorable Booth Gardner,
Chairman Western Governors Assoc.

State of Montana
Office of the Governor
Helena, Montana 59620
406-444-3111

TED SCHWINDEN
GOVERNOR

October 6, 1987

Mr. J. Steven Griles
Assistant Secretary
Department of the Interior
Washington, D. C. 20240

Dear Mr. Griles:

I am writing on behalf of the State of Montana and the Governors of Colorado, New Mexico and Wyoming regarding the Minerals Management Services (MMS) product valuation regulations for coal. Specifically, we want to comment on the recent proposal by industry to change the product valuation formula for federal coal royalties to an Internal Revenue Service (IRS) depletion benchmark with several deductions.

There are alternative methods of calculating the value of federal coal for royalty purposes. The current MMS rules are based on a long record of legal and administrative decisions specifically addressing royalty valuation. We believe MMS should continue to rely on current valuation procedures and not tie federal royalty valuation to the Internal Revenue Code. This could promote much needed stability in federal royalty determinations for coal and other leasable minerals.

The goal of the valuation of coal should be to establish value at the time the coal is first placed in a marketable condition.

The proposed selected exclusions of black lung and abandoned mine land fees from gross proceeds should be rejected. Past practices by states and federal agencies, upheld in court decisions, support the clarity and fairness of an all inclusive definition.

Gross proceeds should include compensation to the lessee from take-or-pay contracts when the contract remains in force. Royalties paid on take-or-pay contracts, where no product is removed from the lease, should be subsequently credited to future production in order to avoid double royalty payments.

Mr. J. Steven Griles
October 6, 1987
Page 2

We recommend that MMS explore alternative netback methodologies and consider different valuation procedures for emerging technologies and draft appropriate guidelines.

Regarding transportation allowances, the Secretary should have the authority to approve documentable actual transportation costs which exceed 50 percent of product value.

Finally, the Secretary should continue to use the royalty reduction tools granted under Section 39 of the Mineral Leasing Act to meet unique hardship conditions.

Additional comments on the Mineral Management Services product valuation regulations for coal may be submitted by individual western governors.

We appreciate the time that you and the MMS staff took to discuss the royalty calculation issue with our representatives on September 28th. The Minerals Management Service is to be complimented for providing a comparative analysis of royalty impacts for the existing royalty formula, Interior's January, 1987 proposal and industry's recent alternative. I am told that the meeting was both candid and productive.

Sincerely,

TED SCHWINDEN
Governor

The Honorable Garrey Carruthers
The Honorable Roy Romer
The Honorable Mike Sullivan

State of Montana
Office of the Governor
Helena, Montana 59620
406-444-3111

TED SCHWINDEN
GOVERNOR

November 25, 1987

The Honorable John Melcher, Chairman
U.S. Senate
Subcommittee on Mineral Resources,
    Development and Production
Committee on Energy and Natural Resources
Washington, D.C. 20810-8150

Dear Senator Melcher:

Last week, I wrote and asked that my October 6, 1987 letter to Assistant Secretary Griles be included in the record for your subcommittee's oversight hearing on the Department of Interior's product valuation regulations for coal. For the record, I would now like to add to my earlier comments.

While differences do exist among Western Governors as to what should be allowed in the royalty base--e.g. the inclusion of royalty or state severance taxes--the letter detailed broad areas where Governors of major western coal producing states do agree, such as continued reliance on gross proceeds valuation procedures. I find little evidence that manipulation of the royalty formula will increase the production of coal in the West. However, the profit margins for western coal producers and/or those who burn western coal would likely be enhanced.

A recent Department of Energy study (attached) estimates future coal production levels for 12.5 percent, 8 percent and 0 percent royalty levels. While small regional or inter-regional changes in production levels may occur as one varies the royalty rate, the study concluded that, nationally, royalty levels have an insignificant impact on coal production. For the year 2000, coal production from the Northern Great Plains, for example, was estimated to be virtually the same assuming either the 12.5 percent royalty rate now coming into effect or no royalty what-so-ever.

Given the DOE assessments, it is certainly hard to defend the almost certain reduction of revenues to the state should the recent proposals by the Minerals Management Service (MMS) or the coal industry be adopted in lieu of current coal royalty calculation methodology. Our Montana Department of Revenue estimates that for the years 1989-

1991, Montana's share of the federal coal royalty income would fall by approximately $3.6 million were the MMS proposal adopted. Under the industry's proposal, royalty revenues to the state would be even lower. In 1990, for example, DOR estimates a $3.3 million reduction.

Montana has in recent years taken significant steps to make our coal more competitive. This was most recently exemplified last April when I signed a bill that provided for an additional phased-in reduction of Montana's severance tax to a level as low as 15 percent by July 1, 1991. In light of these changes and the evidence that decreased royalty levels appear to have little impact on coal production, I believe that Montana would be best served by retention of the current royalty calculation formula.

Sincerely,

Ted Schwinden

TED SCHWINDEN
Governor

Attachment

cc: The Honorable Norman Bangerter
The Honorable Garry Carruthers
The Honorable Roy Romer
The Honorable Mike Sullivan
The Honorable George Sinner
Assistant Secretary Steve Griles

Service Report

Energy Information Administration
U.S. Department of Energy
Washington, DC 20585

SR/CD/87-01

Potential Effects of Changes in Federal Coal Royalty Rates

September 4, 1987

Service Reports are prepared by EIA upon special request and may be based on assumptions specified by the requestor. Information regarding the request for this report is included in the Preface.

PREFACE

This report was prepared in response to a request for a Service Report received on June 1, 1987, from the Director of Planning and Environment under the Deputy Assistant Secretary for Management, Fundamental Research and Cooperative Development, Assistant Secretary for Fossil Energy. The request was made to the Director of the Office of Coal, Nuclear, Electric and Alternate Fuels of the Energy Information Administration (EIA) and assigned to the Coal Division. Details of the request and assumptions are set forth in Chapter 3, "Goals and Approach."

General information concerning this Service Report may be obtained from Charles C. Heath (202/586-6860), Director of the Coal Division, Office of Coal, Nuclear, Electric and Alternate Fuels, or from Robert M. Schnapp, (202/586-1760), Chief of the Data Analysis and Forecasting Branch. Specific information about the preparation and content of the report may be obtained from William Orchard-Hays (202/586-6856), the principal author, or Ernest R. Pantos (202/586-6873), the author of the Background section. Computer modeling and analytical support were provided by Melinda A. Hobbs (202/586-5273) and James R. Littleton, Jr. (202/586-5938).

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EXECUTIVE SUMMARY

This study was undertaken at the request of the Office of Planning and Environment, Assistant Secretary for Fossil Energy, to evaluate the effect on coal production levels, coal prices, electricity prices, and market share of coal for electricity generation of three different levels of Federal royalties on Federal coal leases. The three levels of royalties are as follows:

Scenario C1:	12.5 percent of minemouth cost for surface mines, 8 percent of minemouth cost for underground mines
Scenario C2:	5 percent of minemouth cost for surface mines, 3.2 percent of minemouth cost for underground mines
Scenario C3:	No royalties at all.

Scenario C1 represents the royalties now coming into effect as a result of the 1976 amendments to the Mineral Lands Leasing Act of 1920, which require the renegotiation of leases every 20 years. Previously existing arrangements varied from small fixed amounts per ton to approximately the rates of Scenario C2.

As a result of increasing royalty rates, there is concern that the price of coal from Federal lands may rise to the point that it will be less competitive with alternative sources and fuels -- including oil, gas, and imported coal and/or electricity -- and thus adversely affect the Nation's energy security.

The results of the three cases showed no significant impacts nationally and only modest shifts in production regionally. Electricity prices and market shares of coal for electricity generation appear essentially unaffected.

Eliminating Federal royalties (Scenario C3) did show a shift from eastern to western coal of about 4.5 million tons by the year 2000, out of a total of 1.2 billion short tons of U.S. coal production. Shifts of production within regions were somewhat more pronounced, particularly in the northern Great Plains and Rocky Mountain areas. In general, reduction or elimination of a percentage royalty increases the competitiveness of higher priced coal. However, it does not appear that coal production will be significantly slowed by the royalties now coming into effect (Scenario C1) or accelerated by elimination of royalties (Scenario C3).

1. INTRODUCTION

The request for this study from the Office of Planning and Environment, Assistant Secretary for Fossil Energy, resulted from an issue identified in the Energy Security Review[1] as a potential barrier to maintaining an efficient coal supply chain, namely, whether the level of Federal coal royalty rates now coming into effect will constrain the efficient development of coal on Federal lands. Federal coal royalty rates were mandated by the 1976 amendments to the Mineral Lands Leasing Act of 1920 to rise to a minimum of 12.5 percent of the value of surface coal mined on Federal lands and an administratively established rate of 8 percent of the value of underground coal from new or renegotiated Federal leases. This is a rise from a cents-per-ton basis for pre-1971 leases and from rates of 2.5 to 5 percent for leases acquired between 1971 and 1976. These rates are beginning to take effect now, as many pre-1971 leases reach the end of their 20-year terms and are renegotiated.

The report begins -- following this Introduction -- with a background section covering a brief history of Federal coal royalty regulations, a description of current regulations, and a statistical presentation of recent coal production and royalties from Federal coal leases. After that the study's approach is described, the assumptions are enumerated, and the methodology is discussed. The results of the study are then discussed, comparing potential impacts of three different levels of royalties.

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[1] U.S. Department of Energy, Energy Security: A Report to the President of the United States (Washington, DC, March 1987).

2. BACKGROUND

History[2]

Throughout U.S. history, the disposal of public lands has been a subject of intense controversy. Generally, the debate has been between western business interests, favoring Government policies that would promote rapid development of resources, and conservationists, seeking to restrain the extent and rate of development. Another recurrent issue has been whether the Federal Government has received a fair price for its resources.

The Homestead Act of 1862[3] was enacted to encourage settlement of the West, and the General Mining Law of 1872[4] to encourage development. Early coal leasing procedures were revised in the Coal Lands Act of 1873.[5] However, because of perceived abuses, Federal coal lands were withdrawn from entry in the early 1900's.

The Mineral Lands Leasing Act of 1920,[6] which established the Nation's first comprehensive leasing policy, is the basis of current Federal coal leasing procedures. It provided for two types of coal leases: (1) preference right leases, granted to discoverers of coal under prospecting permits, and (2) competitive leases, issued to persons submitting the highest bonus bids for known coal deposits. Rentals (fixed annual payments per acre) and royalty payments (assessed on production) were specified for both types of lease. These monies were distributed as follows: 37.5 percent to the State where the coal was leased, 52.5 percent to the Reclamation Fund (except that Alaska was allowed to keep this amount as well), and 10 percent to the U.S. Treasury. The Reclamation Fund is a Federal account for financing water projects in western States.

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[2] For an extensive history of Federal energy land leasing policy up to 1975, see Federal Trade Commission, Report to the Federal Trade Commission on Federal Energy Land Policy: Efficiency, Revenue, and Competition (printed for the Committee on Interior and Insular Affairs, U.S. Senate, 94th Congress, 2nd Session, 1976), Chapters 2 and 9.

[3] 43 U.S.C. 61 et seq.

[4] 30 U.S.C. 21 et seq.

[5] 17 Stat. 607, 608.

[6] 30 U.S.C. 181-287.

The Mineral Lands Leasing Act provided for royalties on coal production from Federal lands of not less than 5 cents per ton.[7] The royalty rates were actually set administratively and varied with time and by coal type as follows:

Prior to 1964: From 10 to 15 cents per ton for all coal.

1964-1970: For underground coal, 15 cents per ton over the first 10 years and 17.5 cents per ton thereafter. For surface coal, 2.5 cents per ton higher than for underground coal. Some leases provided for royalties of 20 to 22.5 cents per ton.

The Secretary of the Interior retained the right to renegotiate lease terms, including royalty payments, every 20 years. Rental payments were credited against royalty fees for years when the lease was producing coal. This sometimes resulted in very low royalties, or none at all.

In the 1960's, a sharp increase in the number of coal leases issued, combined with the slow development of existing leases, led to charges of various abuses. As a result, in 1971 the Secretary of the Interior imposed a moratorium on leasing, with minor exceptions. Also in 1971, the royalty system was changed for new or renegotiated leases, from a cents-per-ton basis to a percentage of the minemouth price of the coal mined: 5 percent for surface coal and from 2.5 to 4 percent for underground coal, depending on the depth of the mine. Minimum advance royalties were imposed after the fifth year of the lease, and accelerated rental fee schedules were established. The Federal Coal Leasing Amendments Act of 1976 established a minimum royalty of 12.5 percent of the minemouth price of surface coal production. The Secretary of the Interior was given authority to set a lower royalty on coal recovered by underground mining operations, and that rate has been set administratively at 8 percent. Rental payments were not to be credited against royalty fees for leases issued or readjusted after August 4, 1976. This higher royalty rate applies against all leases acquired after 1976 and to all pre-1976 leases after they are 20 years old.

The first major sales under the new leasing program were held in 1981 and 1982.[8] There was again widespread criticism that the Federal Government received less than the fair market value for the leases, and the sale procedures were also criticized. Therefore, in 1983, Congress imposed a moratorium on coal leasing and directed the Secretary of the Interior to appoint a special commission to review the leasing program. The Commission on Fair Market Value Policy for Federal Coal Leasing (the Linowes Commission) submitted its report to Congress in 1984.[9] The commission expressed concern that the 12.5 percent minimum royalty on surface-mined coal, which may have been chosen to equal the minimum royalty for oil and gas leases, would in some cases be too high for coal leases. It was feared that companies with access to privately held reserves with lower royalties might refuse to bid on Federal leases. This had occurred in lease offerings of Federal coal in Alabama and lignite in North Dakota. The Linowes Commission also recommended that the basis for calculating Federal royalty payments should be the minemouth price minus all State and local severance taxes.

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[7] Tons in this report refer to short tons.

[8] Department of the Interior, Bureau of Land Management, Final Environmental Impact Statement Supplement for the Federal Coal Management Program (Washington, DC, October 1985), Vol. 1, pp. 22-23.

Current Royalty Regulations

Current royalty provisions for Federal coal leases are detailed in the Code of Federal Regulations.[10] Royalty rates are determined on a case-by-case basis, with minimum royalties of 12.5 percent of the value of coal from surface mines and 8 percent of the value of coal from underground mines, with the exception that the authorized officer may set the royalty for underground coal as low as 5 percent if conditions warrant.

The value of coal removed from a mine is defined for royalty purposes as the gross value at the point of sale (normally, the minemouth). Gross value is defined as the contract price times the number of units sold. For captive operations and other cases where contract sales do not exist or may not reflect the true value of the coal, the Minerals Management Service determines the gross value of the coal for royalty purposes. Coal preparation costs incurred prior to sale (such as washing costs) may be deducted from the gross value of the coal for the purpose of determining royalties, with certain exceptions. Coal transportation costs also may be deducted from gross value.

Under special circumstances, the Secretary of the Interior may reduce royalties and rentals (but not to zero for a producing lease) in order to promote development or to encourage the greatest ultimate recovery of Federal coal deposits. Advance royalties may be paid in lieu of continued operation of the mine, in an amount equal to what would be paid on the production of 1 percent of the recoverable reserves. There is a minimum annual rental of $3 per acre. For leases issued before August 4, 1976, until readjusted (20 years after the issuance of the lease), the rental paid for any year is credited against the royalties for that year.

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[9] Fair Market Value Policy for Federal Coal Leasing (Washington, DC, February 1984).

[10] 43 CFR Ch. II.

Recent Coal Production and Royalties from Federal Coal Leases

In 1986, about 19 percent (or 167 million tons) of total U.S. coal production came from Federal coal lands. In the same year, royalties paid to the Federal Government on coal produced from Federal leases amounted to $108.4 million, or approximately 4.4 percent of the value of the coal sold.[11] Table 1 lists the coal production and royalties from Federal coal leases in six of the 10 States where coal was produced from Federal lands during the 1981-1986 period. Coal has been produced from Federal leases in 9 other States (going back to 1920). Very little Federal coal was produced from the 13 unlisted States.

Table 1. Coal Production and Royalties From Federal Coal Leases, 1981-1986

State and Year	Total Coal Production (thousand short tons)	Coal Production From Federal Leases (thousand short tons)	Federal Royalties[a] (thousand dollars)
Colorado			
1981	19,897	11,144	12,892
1982	18,318	9,691	11,642
1983	16,732	10,406	12,960
1984	17,967	11,735	15,171
1985	17,243	9,785	14,728
1986	14,749	10,296	20,738
Montana			
1981	33,561	26,727	6,245
1982	27,890	10,652	9,517
1983	28,930	14,335	7,947
1984	33,000	18,696	9,709
1985	33,290	28,390	15,174
1986	31,997	24,682	22,447
New Mexico			
1981	18,709	9,185	100[b]
1982	19,944	4,404	8,290
1983	20,415	1,593	3,064
1984	21,279	4,648	11,128
1985	22,203	7,722	23,177
1986	20,904	4,254	13,475

(See footnotes at end of table.)

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[11] U.S. Department of the Interior, Minerals Management Service.

Table 1. Coal Production and Royalties From Federal Coal Leases, 1981-1986 (continued)

State and Year	Total Coal Production (thousand short tons)	Coal Production From Federal Leases (thousand short tons)	Federal Royalties[a] (thousand dollars)
Wyoming			
1981	102,969	59,576	17,290
1982	108,361	63,612	21,331
1983	112,214	63,536	21,024
1984	130,914	69,610	23,450
1985	140,714	100,622	27,706
1986	135,241	111,408	28,487
North Dakota			
1981	18,122	874	278
1982	17,855	1,455	1,085
1983	19,190	1,732	1,686
1984	22,112	1,883	1,895
1985	26,873	8,373	7,212
1986	25,186	4,877	6,843
Utah			
1981	13,809	8,719	5,064
1982	17,029	10,925	8,977
1983	11,768	6,725	4,990
1984	12,323	8,327	7,588
1985	12,780	11,185	15,265
1986	12,473	10,631	16,322

[a] Changes in Federal royalties per ton may differ from year to year because of renegotiated royalty payments and audit reviews.

[b] Prior period adjustment.

Sources: •Total Coal Production: Energy Information Administration, Quarterly Coal Report, DOE/EIA-0121(86/4Q) (Washington, DC, April 1987), p. 92. •Coal Production From Federal Leases, Federal Royalties: U.S. Department of the Interior, Minerals Management Service, Mineral Revenues: The 1985 Report on Receipts From Federal and Indian Leases, pp. 31, 38, 40, 41, 47, and 49.

3. GOALS AND APPROACH

This report was prepared in response to a request to analyze the potential effect of different levels of Federal coal royalty rates on coal demand/supply relationships for the years 1990, 1995, and 2000. Additionally, certain specific assumptions were stated in the request. The three scenarios are labeled for reference throughout, as follows:

Scenario C1: 12.5 percent for surface mines, 8 percent for deep mines

Scenario C2: 5 percent for surface mines, 3.2 percent for deep mines

Scenario C3: 0 percent for both (i.e., no royalty).

These scenarios bracket the rates currently coming into effect and the minimum possible (i.e., zero) rates, with C2 approximating the rate for leases acquired between 1971 and 1976. The specific assumptions are as follows:

1. Royalties to be applied to values which conform to current practice and price levels used in the preparation of the Annual Energy Outlook 1986 (AEO86).

2. World oil prices, to the extent possible, assumed to be $21.36 per barrel for 1990, $26.61 for 1995, and $32.87 for 2000. These are costs of imported crude to U.S. refineries expressed in 1986 dollars. (Only 1990 differs from the assumptions for the AEO86, which assumed a world oil price of $17.84 per barrel.)

3. Natural gas prices, to the extent possible, assumed to be $2.65 per million cubic feet for 1990, $3.93 for 1995 and $5.51 for 2000. These are average wellhead prices expressed in 1986 dollars. (Only 1990 differs from the AEO86, which assumed a wellhead price of $2.43 per million cubic feet.)

4. Use of the Intermediate Future Forecasting System (IFFS) to adequately address the questions of fuel switching as well as the potential effect on the elasticity of demand for electricity and coal.

Also, peripheral to running IFFS, an "off-line" analysis was requested, examining the effect of the resulting shifts in coal demand/supply on:

(a) Potential displacement of domestic coal-fired electric generation by imported electricity;

(b) Potential regional displacement of "coal by wire" by expanded oil- and gas-fired generation; and

(c) Potential displacement of domestic coal by expanded coal imports.

The procedure that was followed conformed to the requests as outlined in the preceding section to the fullest extent possible. Adjustments to model inputs and model runs were relatively straightforward. The "off-line" analyses, however, depended on some interpretation of results.

One detail of the request could not be honored: the change in natural gas prices. Due to the way the models are constructed and linked, world oil prices could be, and were, specified as requested. This is not the case with natural gas prices; no practical means of specifying the change were available. However, since only 1990 prices were specified differently from the standard AEO86 prices, and those differed by a relatively small amount, it is likely that the impact would be negligible.

4. METHODOLOGY

This analysis utilized three standard EIA computer models: the Resource Allocation and Mine Costing model (RAMC),[12] the Coal Supply and Transportation Model (CSTM),[13] and the Intermediate Future Forecasting System (IFFS),[14] which was used for the AEO86 and preceding years. The RAMC produces coal supply curves (really step functions) for any of up to 30 underground mine coal types and up to 30 surface mine coal types which are produced in any of 32 supply regions in the United States. The coal types are distinguished by five levels of Btu content and six levels of sulfur content. The underground and surface mines are further categorized by several characteristics including general mine type, size, depth or overburden ratio, and seam thickness. The RAMC is very data intensive and is the primary source of coal supply data for other models at EIA and elsewhere.

The CSTM is the coal supply module for IFFS. It utilizes the supply curves produced by the RAMC. As a submodel to IFFS, the CSTM satisfies specified demands for coal in a number of sectors at 44 domestic demand regions and 4 foreign demand regions, at minimum delivered cost, and returns prices. The CSTM is often run in a standalone mode also but, due to the requirements of this study, it was run under IFFS for final results. This was necessary to capture the effect of different specified prices for oil and gas on the coal and electric utility industries. Minor effects of the change in projected world oil prices were also taken into account in the transportation rates used by the CSTM.

Changes in Federal royalty rates are applied in the RAMC. The RAMC handles Federal coal royalties as part of a generalized set of calculations the primary purpose of which is to derive sales, gross profit, depletion allowance, corporate tax, net profit, and nominal minemouth price per ton for each coal type in each supply region. The Federal coal royalty is applied to the price of the coal at the minemouth. This price includes the cost of capital equipment, operating costs, depletion, Federal income taxes, and a normal return on investment. Operating costs include, among other items, coal preparation, black lung taxes, abandoned mine land fees, and royalties.

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[12] Energy Information Administration, Documentation of the Resource Allocation and Mine Costing (RAMC) Model (Methodology Description), DOE/EIA/M021 (Washington, DC, May 1987).

[13] Energy Information Administration, Coal Supply and Transportation Model (CSTM): Model Description, DOE/EIA/M022 (Washington, DC, June 1987).

[14] Energy Information Administration, Documentation of the Integrating Module and Stock Module of the Intermediate Future Forecasting System, DOE/EIA-M023 (Washington, DC, May 1987).

Although these calculations involve rather complicated expressions, a number of simplifying assumptions are actually employed. In particular, the tax laws of the various States are not represented in detail but through the use of general parameters representing effective rates. Consequently, although the Federal royalty rate is represented explicitly, the precise effects of changing it may not be fully captured and special exceptions (such as a decision to set a particular mine's royalty rate below the nominal standard) are not addressed. Nevertheless, it is believed that, for the most part, the RAMC handles the calculations with a good degree of realism. In fact, because the Federal royalty is included in the value of the coal, a royalty is paid on the royalty. This equates to a 14.06 percent royalty for surface coal and an 8.64 percent royalty for underground coal. The results analyzed in this report reflect this tax-on-a-tax. Supply regions in which at least 70 percent of the 1986 production was from Federal leases were treated as though all production is from Federal leases. This was based on the assumption that private land holders would raise their royalties to match increases at nearby mines. The States in which the Federal coal royalty was applied were Montana, Wyoming, Colorado, and Utah. For these four States, the average share of coal production from Federal leases was 81 percent in 1986.

One issue not addressed was the effect of so-called "due diligence" clauses of Federal leasing laws and regulations. Generally, a lessee must be producing on a lease in commercial quantities (defined as at least 1 percent of the mining unit's reserves in a year) within 10 years or relinquish the lease. In some cases, the lessee has other options, such as paying advance royalties. However, negligence or willful delays can result in penalties such as being prohibited from bidding on any Federal mineral leases (not just coal). The new ruling that rents no longer apply against royalties also has an effect. Thus, in a soft coal market with an uncertain future, a lessee or potential lessee is faced with a difficult risk decision as to how much to invest to hold a potentially valuable but uncertain option. A study of this issue was not requested and, as a practical matter, no means exist for addressing it in a short time frame. However, it may well be the dominant issue with respect to leasing regulations.

Full results of the model outputs have been provided to the Office of Fossil Energy, but for convenience a summary of the results is presented next.

5. IMPACTS DUE TO ROYALTY CHANGES

Production Levels

The results of this analysis indicate that the impacts on coal production due to royalty changes are all relatively small (Table 2). As could be expected, the projections show that the only significant impacts of lower royalty rates are increased western coal production and decreased eastern coal production. Coal production shifts from the East to the West by an insignificant amount in 1990, by about 4 million tons in 1995, and by between 4 million and 5 million tons in 2000. The changes are not uniform, however. The Northern Wyoming region (in the Northern Great Plains) is projected to have lower coal production levels as the royalty is reduced across the scenarios. Its nearby western neighbors in both the Northern Great Plains and Rocky Mountain regions would be the beneficiaries: as royalties are reduced, minemouth prices in States with high-priced coal are reduced by a larger absolute amount, enhancing their competitiveness.

In addition, in the East, southern West Virginia (Central Appalachia) coal is displaced by coal from the Rocky Mountain region as the royalty rates decline across the scenarios. Other Appalachian regions incur smaller losses. In the Midwest region, Illinois coal is also displaced by Rocky Mountain coal. Many coal-producing regions experience no significant change at all due to changes in royalty rates. This is particularly true of the Western Interior. Because the coal royalty was assumed to apply to all Federal and non-Federal lands in the four western States affected, and because the analysis was not performed at the lease level, some additional shifts within and between States may not be captured in these results.

Prices

No significant changes in projected average electricity price occur in any region in any year among any of the scenarios. The biggest differences are between 0.4 and 0.5 mills per kilowatt hour (0.7 percent) in the Central demand region (Kansas, Nebraska, Iowa, and Missouri). The largest national difference is only about 0.2 mills per kilowatthour (0.3 percent) between the no royalty and highest royalty cases (Table 3).

The changes in projected coal prices are similarly insignificant in the East and nationally. The largest national average change is $0.48 per ton -- less than 2 percent (Table 4). However, the minemouth prices for western coal are about $1.00 to $1.30 per ton lower in Scenario C3 than in Scenario C1. In spite of this, domestic consumption of western coal remains essentially constant in all demand areas. However, exports of western coal in the year 2000 are 4 million tons higher in Scenario C3 than in Scenario C1. This represents a difference of 85 percent for western exports (from 4.7 million tons in Scenario C1 to 8.7 million tons in Scenario C3), primarily at the expense of the Appalachian area, which loses about 3 million tons (or 3 percent) of its exports.

Table 2. Projected Coal Production by Target Year and Scenario (Million Short Tons)

Region	Scenario C1	Scenario C2	Scenario C3
	[illegible]	[illegible]	[illegible]
		1990	
Northern Appalachia	199	199	199
Central Appalachia	252	252	252
Southern Appalachia	30	30	30
Midwest	157	157	157
Western Interior	61	61	61
Northern Great Plains	207	208	208
Mountain and Southwest	72	72	72
Northwest and Alaska	5	5	5
Appalachia	482	482	482
Interior	218	218	218
Western	284	284	285
East of the Mississippi ...	639	639	640
West of the Mississippi ...	345	345	345
Total	984	984	984
		1995	
Northern Appalachia	228	228	228
Central Appalachia	260	259	257
Southern Appalachia	34	34	34
Midwest	176	176	176
Western Interior	80	80	80
Northern Great Plains	228	229	229
Mountain and Southwest	81	83	85
Northwest and Alaska	6	5	5
Appalachia	522	521	519
Interior	256	255	255
Western	315	317	319
East of the Mississippi ...	698	696	694
West of the Mississippi ...	395	397	399
Total	1,093	1,093	1,093

(See footnotes at end of table.)

Table 2. Projected Coal Production by Target Year and Scenario (continued)

Region	Scenario C1	Scenario C2	Scenario C3
	12 5%	5%	6%
		2000	
Northern Appalachia	255	254	254
Central Appalachia	268	265	263
Southern Appalachia	32	32	32
Midwest	183	183	182
Western Interior	101	101	101
Northern Great Plains	252	253	252
Mountain and Southwest	89	90	92
Northwest and Alaska	2	2	2
Appalachia	554	552	552
Interior	284	284	282
Western	341	345	346
East of the Mississippi ...	737	734	733
West of the Mississippi ...	442	445	447
Total	1,180	1,180	1,180

Note: Totals may not equal sum of components due to independent rounding.

Source: Energy Information Administration, Intermediate Future Forecasting System, COALC1, COALC2, COALC3.D0820871.

Table 3. Projected Average U.S. Electricity Prices by Target Year and Scenario (1986 Mills per kWh)

Year	Scenario C1	Scenario C2	Scenario C3
1990	61.26	61.16	61.10
1995	58.98	58.88	58.83
2000	61.52	61.41	61.35

Source: Energy Information Administration, Intermediate Future Forecasting System, COALC1, COALC2, COALC3.D0820871.

Table 4. Projected Average U.S. Coal Prices by Target Year and Scenario (1986 Dollars per Short Ton)

	Scenario		
Year	C1	C2	C3
1990	26.59	26.33	26.18
1995	29.10	28.81	28.62
2000	29.31	29.01	28.84

Source: Energy Information Administration, Intermediate Future Forecasting System, COALC1, COALC2, COALC3.D0820871.

Impact on Imports of Electricity and Coal

The estimates used by EIA for electricity imports were developed by the Economic Regulatory Administration. Although these estimates were provided exogenously to the EIA modeling system, the insignificant changes in electricity prices would not be expected to cause any changes in imported electricity. Changes in electricity prices of at least one and perhaps two orders of magnitude greater would seem to be necessary to cause any impact on electricity import arrangements.

By the same reasoning, no significant impact is foreseen on coal imports by a reduction in royalties from the full amounts (12.5 percent and 8 percent) to no Federal royalties. However, a shift in export supply to western coal from eastern coal of about 4 million tons was noted. This is based strictly on production and inland transportation costs and does not take into account various other factors of international coal trade.

Impact on Coal versus Oil/Gas Usage

It is clear that lower coal royalty rates cause some shifts in coal production and distribution and that these effects, though small, reverberate across the country. However, it appears that the coal supply industry could adjust to the changes, since it is projected to continue to maintain its market share as a whole. Because delivered coal prices are not projected to change by more than $0.03 per million Btu (Table 5), utility use of steam coal in terms of Btu consumed is projected to change hardly at all between Scenarios C1 and C3 (Table 6). This held regionally as well as nationally, and for all years.

Hence, no impact is foreseen on "coal-by-wire" due to expanded oil- and gas-fired generation. Possibly there may be local effects on generation and transmission which have not been detected, but these are not likely to be very large or extensive.

Table 5. Projected Electric Utility Fuel Prices by Target Year and Scenario
(1986 Dollars per Million Btu)

	Fuel Type							
	Coal		Natural Gas		Fossil Fuels		All Fuels	
Year	C1	C3	C1	C3	C1	C3	C1	C3
1990	1.69	1.67	2.62	2.62	1.88	1.86	1.41	1.40
1995	1.82	1.80	4.29	4.29	2.47	2.46	1.87	1.86
2000	1.89	1.85	5.63	5.63	2.98	2.96	2.29	2.28

Source: Energy Information Administration, Intermediate Future Forecasting System, COALC1, COALC3.D0820871.

Table 6. Projected Electric Utility Fuel Consumption by Target Year and Scenario
(Trillion Btu per Year)

	Fuel Type							
	Coal		Natural Gas		Fossil Fuels		All Fuels	
Year	C1	C3	C1	C3	C1	C3	C1	C3
1990	15,995	16,001	2,949	2,949	19,868	19,874	29,045	29,051
1995	18,054	18,057	4,251	4,253	24,414	24,442	33,967	33,976
2000	19,479	19,479	5,054	5,049	27,930	27,923	37,604	37,598

Source: Energy Information Administration, Intermediate Future Forecasting System, COALC1, COALC3.D0820871.

Conclusion

On a national level, the effects of reduced Federal coal royalties are insignificant. Regionally, reduced royalties cause minor shifts in coal production and exports from the East to the West. At a smaller regional detail, some displacements are more noticeable, particularly from the Powder River Basin to its western neighbors, but even those are quite small.

These results are based on a number of assumptions and simplifications which may or may not hold true in detail over time. The effect of decreased royalties, however, would appear to be almost unnoticeable in the near term and to be very moderate even 10 to 15 years hence.

STATE OF WYOMING
OFFICE OF THE GOVERNOR
CHEYENNE 82002

MIKE SULLIVAN
GOVERNOR

October 6, 1987

Steven Griles, Assistant Secretary
Land and Minerals Management
U.S. Department of Interior
Washington, D. C. 20240

Dear Steve:

I would first like to apologize for any confusion created by "commenting on comments" as to the industry coal valuation proposal currently under consideration by your agency. You may have already received the consensus position which was recently finalized by several western governors of coal-producing states. I would like to take this opportunity to discuss some issues in greater detail.

While I appreciate the concerns which surface with any proposal that fundamentally changes valuation methodology along the lines of the industry proposal, I believe a thorough analysis of the proposal is demanded. The coal and utility industry clearly invested quite a bit of effort in developing and explaining the proposal to federal and state officials. We owe them similar, good faith efforts in evaluating the proposal.

During any evaluation of the industry proposal, one point demands attention. Basically the depletion approach provides the same starting point for valuation purposes in the "simple" cases, except that royalty reimbursements are excluded. The questions and concerns which surface on depletion are within the context of operations which may include non-mining costs within the calculation for the price of coal, or operations which may not include buyer prepayments or non-cash consideration.

I have accepted the joint decision that "gross proceeds" should not be abandoned for coal valuation purposes. However I believe some recognition should be given to the potential administrative efficiency of the depletion approach in the "simple" case where gross proceeds equates to book sales.

I would now like to address the issue of allowances. After much consideration of our past position that "gross proceeds" should be all-inclusive, I have decided to depart from this position for coal valuation purposes only and recommend the exclusion of royalty reimbursements from gross proceeds. I take this stand based primarily on my concern that the increased royalty through lease readjustments will have a negative effect on maintaining and enhancing a market share for federal coal production. In addition, I can find this issue distinguishable from other taxes and fees based on the argument that the effect of "compounding royalties" results in the lessee paying a royalty rate higher than the statutory royalty. With the government charging a royalty on a royalty (to infinity), the effective royalty rate for Federal leases becomes 14.3%, rather than 12.5%.

I also would like to address the issue of including take-or-pay payments within "gross proceeds". I believe the investment, and the mining and reclamation obligations which are involved in opening and developing a coal mine and which are continuing, justify distinguishing take-or-pay payments for coal valuation purposes from similar payments within the context of oil and gas production. Therefore, I would recommend that take-or-pay payments be excluded from the gross proceeds definition when no coal is produced and sold from the lease, or if it is included, that an offset be allowed once the coal is sold.

Finally, I would like to restate my comments on emerging coal technologies. Within this context, I believe that MMS should value the coal based on a fixed valuation point. That point should be when the coal first achieves marketability.

I appreciate your consideration of my comments. With best regards, I am

Yours sincerely,

Mike Sullivan

Mike Sullivan
Governor

MS:nf

State of North Dakota
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NORTH DAKOTA
CENTENNIAL

GEORGE A. SINNER
GOVERNOR

October 26, 1987

Mr. J. Steven Griles
Assistant Secretary
Land and Minerals Management
United States Department of the Interior
C Street Between Eighteenth
and Nineteenth Streets, Northwest
Washington, D.C. 20240

Dear Mr. Griles:

I have reviewed an October 6, 1987, letter to you from Governor Schwinden on behalf of the State of Montana and the Governors of Colorado, New Mexico, and Wyoming, regarding federal coal royalty valuation. I would like to take this opportunity to comment on the issues raised in that letter and the discussions held on September 28 between you and your staff and representatives of the above governors and myself.

I am in basic agreement with much of Governor Schwinden's letter. However, since I feel there are flaws in the current system, I am not able to support the long-term preservation of that system in its entirety. Rather, it is my belief that the various issues involved in coal royalty valuation should remain the subject of an on-going review in an attempt to arrive at a formula which is equitable in all situations where federal coal is marketed.

As we have previously discussed, I have a particular concern regarding federal coal royalty valuation methodology as it is applied to North Dakota lignite. Because virtually all (99% or more) of North Dakota's lignite production is sold under long-term "cost plus" contracts, there really is no independent determination of market value for this coal (at least not in the way the concept of market value is usually defined). Rather, lignite producers find themselves in a situation where the relatively high mining costs encountered in North Dakota arbitrarily result in increased federal coal royalties, without regard to the true value of the coal being mined. The problem is that captive buyers with other investment considerations in mine mouth facilities often get taxed well above coal value on the open market. That hurts prospective development of additional facilities.

Thus, this combination of long-term cost plus contracts with the federal royalty valuation methodology has resulted in royalties on North Dakota lignite being double or even triple the royalty paid on much of the coal sold in other western states, even though North Dakota lignite has a much lower intrinsic value.

Thus, while I support the thought and effort that has gone into the valuation review process, I remain convinced that there is a continuing need to explore alternative valuation methods for low-BTU coal sold under long-term cost plus contracts.

Sincerely,

George

George A. Sinner
Governor

GAS:lk

cc: The Honorable Ted Schwinden
The Honorable Garrey Carruthers
The Honorable Roy Romer
The Honorable Mike Sullivan

STATE OF COLORADO

EXECUTIVE CHAMBERS
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Phone (303) 866-2471

1876

Roy Romer
Governor

October 9, 1987

Mr. Dennis Whitcomb
Chief
Mineral Management Services
Denver Federal Center
Building 85, M/S 628
P.O. Box 25165
Denver, Colorado 80225

Dear Mr. Whitcomb:

Colorado is very appreciative of the time taken by Assistant Secretary Griles to brief the western states on the financial impacts of the various coal royalty rate valuation methodologies currently under review. The analysis provided by Mr. Griles proved very useful in understanding the components of coal royalty revenues. It also provided an opportunity to discuss the various industry proposals that have been made in the context of both the current rules and the Mineral Management Service's proposed rules.

Over Governor Ted Schwinden of Montana's signature, a letter is being sent to you conveying the consensus among western states on items for inclusion in the calculation of royalty rates. The letter also indicates that several states would provide more specific comments.

The comments we submitted on April 25, 1987, reflected the consensus philosophy of state and local governments in Colorado regarding coal royalty valuations. Our July 23rd letter set the target for an acceptable revenue level as a result of methodology changes. Copies of those letters are attached for the record. This letter is intended to suggest ways to achieve the royalty levels we feel are critical to the survival of the state's coal industry.

In concept, Colorado agrees with the basic comments in Governor Schwinden's letter, but we do not believe that they go far enough to aid this distressed industry and the affected local economies. In July 1987, I provided Colorado's proposal for coal royalty valuation. I also requested the regulatory impact analysis which Assistant Secretary Griles provided last week. In our proposal, Colorado identified its willingness to reduce its share of the federal coal royalty revenues by $3.5 million a year from the 1986 level of $10 million to accommodate the current status of Colorado's coal industry. A revenue level of $6.5 million is equivalent to the state's share of 1984 federal coal royalties before many of the pre 1976 leases were readjusted.

Consistent with our April and July comments and using the financial information provided by Assistant Secretary Griles, I would like to propose the following areas where royalty rate reductions could be made to achieve our goal.

Since our bottom line is revenue oriented, the point in the value-added process where taxation occurs is best determined by tax specialists; however, royalties should represent the value of the product removed from the lease. In addition, we continue to support our previous comments on arms-length contract definitions.

Black lung, abandoned mine, severance tax and royalty-on-royalty payments are fees which add no value to the product and raise the price to the consumer. Historically, the western states have opposed the exclusion of black lung and abandoned mine fees from the calculation of royalty rates. Colorado concurs that these are special use taxes which may properly continue to be part of the value of the coal because of the ways in which the derived revenues are distributed. However, the issue of severance taxes and royalty-on-royalty payments is somewhat different. Those revenues are dollars that go for a variety of uses which may or may not be directly related to the mining industry. As a result, we feel that those taxes should be exempted from the royalty rate calculation.

Colorado concurs with Governor Schwinden's comments on transportation costs. The high cost of transporting Colorado coal to market makes it imperative that documentable transportation costs be a deductible item in the calculation of the royalty payments.

Colorado continues to support the discretion of the Secretary of the Interior to reduce royalty rates on a case-by-case hardship basis. This reduction should occur not only based on a severe economic hardship, but also if the royalty, together with the other factors of production, makes the resource uneconomic to produce. While I understand that this requires significant auditing responsibilities, it will provide help which is critical to those companies that are in true need of financial assistance at this time.

Colorado continues to support the position that revenues derived from take-or-pay contracts where product is not removed from the lease should be taxed as income and not included in the royalty base. At a minimum, payments should be credited against future production.

Finally, several underground coal companies have proposed that underground coal royalty rates be reduced across the board from 8 percent to 5 percent. We are aware of the critical competitive situation facing several underground operations, not only in Colorado, but in other states around the country. For that reason, Colorado supports a reduction in coal royalty rates for a period of three years for those high-cost underground leases where the cost of production places that operation in a competitive disadvantage with other surface or underground operations in the area. At the end of that time frame, we request an evaluation of this reduction with regard to enhanced competitiveness. If the royalty reduction is shown to contribute to increased underground coal activity, such a policy could be continued. This approach is consistent with that taken by Colorado in reducing coal severance tax rates for a temporary period to provide relief during the current depressed market.

In addition, dismissal of some of the current lawsuits regarding underground coal royalty rates would release funds currently escrowed for other economic purposes to aid the industry and their customers.

Overall, we feel that our proposal for coal royalty valuation would achieve the $3.5 million reduction in royalty payments necessary to keep the coal industry in Colorado moving while maintaining a baseline revenue of $6.5 million for state and local governments.

The components for our proposal are:

- Exclusion of royalty-on-royalty payments which amount to a state share of $1.75 million per year;
- Exclusion of severance tax payments which amounts to $0.6 million a year;
- A three-year hardship reduction in royalty rates for high cost underground coal mining operations from 8 percent to 5 percent, which could amount to as much as $0.5 million a year;
- Royalty rate reductions in hardship cases for surface mines (financial impact unknown);
- Exclusion of revenues derived from take-or-pay contracts where no product is removed from the lease (financial impact unknown); and
- Exclusion of documentable transportation costs (financial impact unknown).

This proposal is based on the revenue figures provided by Assistant Secretary Griles. The combination of severance tax, royalty-on-royalty and underground royalty reductions on a case-by-case basis could amount to $2.85 million per year. The impact of deductions for the transportation allowance, take-or-pay provisions and hardship reductions for surface operations is unknown. Should the combination of these three elements result in revenues dropping below $6.5 million, appropriate changes would be made to assure that the exemptions are consistent with the revenue goal.

Resource Data International of Denver has provided a financial analysis of the Colorado proposal (Exhibit I). It shows that our proposal, in its simplicity, is comparable to the more complex industry proposal with regard to ultimate revenues to the state.

A position of no changes from the current royalty system would certainly maximize revenues in the short-term. However, we recognize that a policy of no change would not be conducive to the long-term health of the coal industry in Colorado. Our proposal is simple, fair and equitable recognizing not only the manner in which the coal business is conducted, but also responding to the current financial plight of the industry.

We appreciate the opportunity to comment further on these proposed regulations. This proposal represents the consensus of state and local government in consultation with Colorado's coal industry. We feel that the measures outlined in this letter will significantly enhance the competitiveness of Colorado coal and stabilize an industry on the decline in our state.

Sincerely,

Roy Romer

Roy Romer
Governor

RR:jgk

EXHIBIT I

COMPARISON OF VARIOUS METHODS OF CALCULATING ROYALTIES ON COLORADO COAL

	FULL DOI RATES	COLORADO PROPOSAL	INDUSTRY PROPOSAL
Surface mine royalty rates	12.50%	12.50%	12.50%
UG mine royalty rates	8%	5%	8%
Total Production (mmt)	15.2	15.2	15.2
Federal Production (mmt)	8.8	8.8	8.8
Effective Royalty Rate	10.50%	9.50%	10.50%
Base FOB mine price ($/ton)	21.72	21.72	21.72
Adjusted FOB mine price ($/ton)	22.92	22.7	22.92
Gross value of federal coal (mm$)	201.70	199.76	201.70
Royalties (mm$)		18.98	21.18
Severance on federal coal (mm$)		5.66	5.66
Black lung on federal coal (mm$)			6.07
Reclamation on federal coal (mm$)			2.38
Adjusted value (mm$)		175.12	174.86
Royalties (mm$)	21.35	16.64	18.36
State 1/2 of royalties (mm$)	10.67	8.32*	9.18
Revenue for state leases & other taxes	22.35	22.35	22.35
Total direct state revenues (mm$)	33.02	30.67	31.53

Source: Resource Data International
Denver, Colorado

* Assumes across-the-board royalty rate reduction for all underground operations. Impact will be less for reductions applicable to high cost operations only. Does not include financial impact of transportation allowance, hardship reduction for surface operations, take-or-pay contracts.

STATE OF COLORADO

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Phone (303) 866-2471

Roy Romer
Governor

July 23, 1987

Dennis Whitcomb
Minerals Management Service
Building 85, Denver Federal Center
P.O. Box 25165, Mail Stop 628
Denver, CO 80225

Dear Mr. Whitcomb:

Colorado would like to revise its comments on proposed coal valuation regulations, submitted in April 15, 1987, now that the coal and utility industries have reached a compromise on the coal valuation regulations and the Bureau of Land Management has issued guidelines on royalty rate reductions.

In April, we addressed the fairness of Minerals Management Service's proposals for Colorado companies. Those comments focused on the definition of arms-length contracts, gross proceeds, allowances for extraordinary transportation costs, exclusion of "pay" provisions in take-or-pay contracts for royalty purposes and the framework for royalty rate reductions.

In general, we asked that the MMS to consider issues such as market standing, the factors of production which may be unique to Colorado, the conditions under which long-term contracts are determined, and the reliability of the revenue source derived from the development of Colorado's energy resources.

Central to the consensus based on the Edison Electric Institute proposal is the point at which valuation occurs for royalty calculations. The institute also proposed deducting fees prior to royalty calculation. As we understand the proposal, the recommendation suggests that the federal depletion point of determination be chosen as the valuation point for royalty purposes. This coincides with the current MMS valuation point. At this value point, the abandoned mine, black lung, state severence tax and royalty-on-royalty payments would not be included.

The proposal has merit. It sets the value at the point before non-mining costs are added, which is current MMS practice. The deduction of fees is logical in that these fees add no value to the product.

Such a proposal, however, does not come without financial impact to state and local royalty revenues. In recent years, pre-1976 leases have been renegotiated at higher royalty rates. Total federal and state royalties in Colorado increased nearly 50 percent in two years, from $13.1 million in federal fiscal year 1984 to $20.0 million in federal fiscal year 1986, which was a period of declining production. As renegotiation of pre-1976 leases is completed in the next few years, this figure could be higher. The deduction of the above fees would reduce the rate of such increases. Colorado believes the proposal would maximize long-range revenues to the state by increasing the competitiveness of Colorado coal and, perhaps, enhancing the economics of marginal operations.

This, however, is only a partial picture. This month's MMS guidelines on royalty rate reductions also will affect royalty revenues. The guidelines focus on promoting development and improving the economics of an operation. Such reductions would be based on geologic and engineering data.

Colorado supports the discretion of the secretary of the Interior to reduce royalty rates on a case-by-case basis where the royalty rate combined with other factors of production would make the resource uneconomic to produce. The proposed guidelines seem to focus more on geology and engineering rather than economics. It is our intent that such reductions should improve the economics of an operation but should not be financial compensation for poor business decisions. In providing state concurrence for a royalty reduction, documentation will be requested for the economic justification of royalty rate reduction requests on a case-by-case basis, possibly subject to audit. Such information will be shared with the affected local entities prior to a decision on concurrence.

Across the board royalty rate reductions based on loosely defined justifications couplec with the Edison Electric proposal for deductions of non-mining fees will certainly reduce revenues from their current levels. in consultation with local governments, the 1984 federal fiscal year revenue level has been identified as a minimum acceptable income level. Such a level which is below current revenues does provide flexibility for royalty rate reductions as well as the types of non-mining fees to be deducted for royalty calculations. For this reason, Colorado reiterates the request made in our April 15, 1987, letter for a regulatory impact analysis by state of the proposed modifications and substantial royalty reductions to assure the revenues after these adjustments do not fall below this minimum income level.

Our intention continues to be the reinforcement of the coal mining industry in Colorado with flexibile royalty rate levels which reflect actual economic conditions and with a royalty structure which reflects the true value of the product. A viable coal industry is one that continues to pay severance and property taxes, provides royalty payments and impact mitigations fees, employs our citizens and providesdomestic energy resources.

We hope such flexibility will allow the industry to expand. Colorado supports rules and regulations that reflect the changing nature of the industry, encourage new projects and open new markets and that encourage existing mines to expand their operations. We want to foster these changes without short-term loss to state and local governments while protecting long term revenues by maintaining a healthy industry.

These comments reflect a consensus of state agencies, local Colorado governments and state mineral royalty specialists.

Thank you for your consideration.

Sincerely,

Roy Romer

Roy Romer
Governor

STATE OF COLORADO

EXECUTIVE CHAMBERS
136 State Capitol
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Phone (303) 866-2471

Roy Romer
Governor

April 15, 1987

Mr. Dennis Whitcomb, Chief
Minerals Management Service
Building 85, Denver Federal Center
P.O. Box 25165, Mail Stop 628
Denver, Colorado 80225

Dear Mr. Whitcomb:

Colorado appreciates the opportunity to comment on the proposed regulations governing the valuation of federal oil, natural gas and coal for royalty purposes, and on the guidelines under which the department will grant reductions from the statutory royalty rates. While the state does not have jurisdiction over federal royalty issues, it has a keen interest in the rules and regulations which affect industries vital to the state's economy.

The oil, gas and coal industries have contributed significantly to Colorado's economy over the past 100 years. Coal production has dropped in recent years, amounting to 17 million tons in 1986 and accounting for only half of the total employment of the early 1980's. Oil production has fluctuated around the 1986 level of 29 million barrels. Natural gas production is stable, at a level of 171 trillion cubic feet last year. Colorado's economy has been very sensitive to the dramatic changes in these industries.

Any proposed rules and regulations must reflect the changing nature of the industry, serve to encourage rather than discourage new projects, and allow existing operations to identify new markets, to re-open existing mines or to operate closer to capacity. These issues are especially critical when the cost of producing Colorado coal is compared to the cost of production in other western states. The cost here is often three times higher due to complex geology and transportation.

Our comments address the equity of the proposed rules for Colorado's market standing compared to other western states, the factors of production which may be unique to Colorado, the conditions under which long-term contracts were determined, and the reliability of the revenue source derived from the development of Colorado's energy resources.

We offer the following recommendations:

Coal

- Arms-length contracts

  The definition proposed by the Minerals Management Service (MMS) is neither comprehensive nor definitive. Interior should adopt the definition proposed to MMS in the draft regulations submitted by the Royalty Management Advisory Committee.

  However, this regulation should allow for a right of review and possible adjustment in those extraordinary cases where contracts were arms-length at their inception and where an ownership interest was subsequently obtained and the contract not amended. Obviously, changing the regulations mid-stream in a long-term contract can significantly change the economics of the deal. The simple provisions for a pass-through of increased costs does not help the ultimate consumer. We recommend that MMS establish a review and adjustment process for such contracts to prevent immediate disqualification of the contract price and substitution of a coal value for royalty purposes which could exceed both the current value established by the contract and the fair market value of the coal.

- Definition of Gross Proceeds

  The proposed definition of gross proceeds in the calculation of royalty payments allows the exclusion of some fees paid by the industry but not others. This would create an apparent inconsistency by taxing some fees through the royalty system which are then recovered in the cost to the ultimate consumer and excluding others.

  For this reason, Colorado proposes that a Regulatory Impact Analysis by state be performed prior to the implementation of this revised regulation. This effort should produce a royalty system and a gross proceeds definition which assign royalty rates to the production of the resource and a tax structure to the income from the sale of the product. The current system mixes these concepts resulting in royalties on fees in addition to royalties on production. The analysis should also investigate the program's economic impact on the coal industry, state revenues and the federal budget.

- Transportation Allowances

  Transportation costs are critical to the ability to market Colorado coal. Several coal operators in Colorado are investigating markets as far away as the Pacific rim. The cost of producing Colorado coal coupled with a restricted transportation allowance could severely limit the marketability of Colorado coal.

  The state urges that allowance be made for reasonable transportation costs. To avoid possible abuses of this allowance, MMS should retain the ability to challenge inappropriate or unnecessary transportation allowances. Should the 50 percent ceiling remain, hardship exemption criteria should be established which includes a determination as to whether or not extraordinary transportation costs in conjunction with other factors would make the resource uneconomic to produce.

- Take-or-Pay Contracts

  Colorado believes that royalty payments should be based on a fair market price determined by an arms length process. They should not be based on prices that are not actually realized, products that are never sold, or income that is not received.

  The inclusion of payments for product not taken in the gross proceeds definition for royalty purposes is inappropriate. While inclusion would certainly increase revenues to the state, these revenues would be derived from coal which is never produced or removed from the lease. Under this proposal, royalty rates would vary in real terms from company to company even more than they do now depending on the percentage deviation between the coal sold and retained under the take-or-pay contract. This would not be equitable and could place unfair economic burdens on some companies.

  The state does, however, believe that payments for product not taken which are received under take-or-pay contracts are taxable income. If revenues are received under a take-or-pay contract in which no product is traded, the resulting revenue should be taxed by state and federal government as income and not as a royalty.

Royalty Rates

Colorado along with the other western states has opposed and continues to oppose the across-the-board reduction of royalty rates. However, the state is sensitive to the increase that some mine operators may receive as pre-1976 royalty rates are readjusted to 12 1/2 percent. In some instances, this could be a 2000 percent increase.

The State supports the discretion of the secretary of interior to reduce royalty rates on a case-by-case hardship basis. State representatives met in March with BLM Director Burford to discuss the criteria that BLM intends to apply to the reductions. We are comfortable with the rigorous nature of the analysis being proposed along with the subregion comparison that BLM intends to use. Colorado requests that the criteria that an operation be losing money as the basis for a reduction be expanded to include the following: a hardship reduction in royalty rates should be granted if the rate, in combination with other factors, makes the resource or any substantial part thereof uneconomic to produce.

Oil Valuation

o Arms-length contract

The MMS definition of arms-length contract could, in the extreme, eliminate the vast majority of what are now defined as arms-length contracts from qualifying as such. It also forecloses the use of standard price checks to assure that contract proceeds meet the statutory requirement of fair market value of production.

The state recommends the adoption of the arms-length definition proposed by the Royalty Management Advisory Committee. It allows for more accurate results in determining valuation for royalty purposes. The appeals process is in place to protect the lessees from arbitrary decisions regarding determinations of arms-length contracts.

o Benchmark System

The proposed regulations would establish a benchmark system to set posted prices in the event that the contract is not arms-length. It is difficult to establish an alternate system to calculate fair market value. The variability in the quality of the resource coupled with different operations costs may not assure comparability between operations in a given area in establishing the fair market value under the benchmark system. MMS should use the posted price criteria of the benchmark system verified by a netback analysis to assure the credibility of posted prices.

- Transportation allowances

  As with coal transportation allowances, reasonable costs of oil transportation should be allowed. MMS should be allowed to review such costs and impose limitations on unjustified allowances. If the 50 percent limitation is maintained, hardship exemption criteria also should be adopted. An exemption from the 50 percent limitation should be seriously considered if such costs in combination with other regulatory factors make the resource uneconomic to produce.

Gas Valuation

- Benchmarks in lieu of arms-length contracts

  The majority of gas contracts are not arms-length contracts. The benchmark system proposed by MMS may be too complex.

  The state proposes that MMS study the numerous pricing provisions related to gas sales and establish federal floor values which could be used easily by lessees to compute a minimum royalty.

- Transportation allowances

  Again, the state proposes handling transportation allowances in the same manner as recommended for oil.

I appreciate your attention to these comments. Colorado strives to achieve a fair and balanced approach to the regulation of the energy industry while maintaining revenues to the state from the production of their energy resources.

Sincerely,

Roy Romer

Roy Romer
Governor

RR:11:4440A

Union Pacific
Resources
A Subsidiary of Union Pacific Corporation

Eugene A. Lang
Senior Vice President
Minerals

December 7, 1987

The Honorable John Melcher
Chairman
Mineral Resources and
  Production Subcommittee
362 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Melcher:

On November 16th, your Mineral Resources and Production Subcommittee held hearings on the Interior Department's Proposed Coal Product Valuation Regulations.

Union Pacific Resources, which as a result of corporate reorganization includes what was previously known as Rocky Mountain Energy, would like to submit the attached comments for the record.

Sincerely,

Gene Lang

Eugene A. Lang

cc: The Honorable James A. McClure
    Members of the Senate Energy Committee

Union Pacific Resources Company
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COMMENTS OF UNION PACIFIC RESOURCES
TO THE
SENATE ENERGY AND NATURAL RESOURCES COMMITTEE
SUBCOMMITTEE ON MINERAL RESOURCES DEVELOPMENT AND PRODUCTION
NOVEMBER, 1987
ON THE
"Proposed Coal Product Valuation Regulations"

Union Pacific Resources is a wholly owned subsidiary of Union Pacific Corporation and as a result of a corporate reorganization includes what was Rocky Mountain Energy Company. We are pleased to have this opportunity to provide our thoughts on proposed coal product valuation rules. We feel that, as coal lessors and lessees, we are in a unique position to comment on this important issue.

The valuation question has been growing in importance since Congress directed in 1976 that future royalties from federal coal be based on a percentage of the value of the coal and not on the flat rate of so many cents per ton. Royalty payments are rising and will continue to rise over the next several years as the Department of the Interior (DOI) implements Congress' mandate. As a result, DOI is being pressed to change the way "value" is defined so that royalty increases can be minimized. We believe much of this pressure is misplaced.

Reimbursements of Producer Costs

We believe that a mineral owner should be fairly compensated. While we recognize that fair compensation can take on different meanings with different people, in our view Congress intended that the "value" subject to royalty should include the entire consideration that a lessee actually receives for coal it produced, regardless of the form that the consideration takes.

When a buyer agrees to pay a higher price by covering costs of the producer, the lessee has obviously received an economic benefit, and the value of the benefit is one that the buyer is willing to pay in order to obtain the coal. Some have argued that reimbursements for taxes or fees are not payments for the value of the coal, but these arguments are not persuasive. The costs that a purchaser agrees to reimburse are part of what he is willing to pay for the coal. It makes no difference to the purchaser whether the amount he is paying is for taxes or for other costs. The premise of Congress' change to a value-based royalty system over the centers-per-ton system is that, if the purchaser is willing to pay more for the coal, the mineral owner should share in the increased value.

One of the arguments raised against including fees within the definition of value is that the government could increase royalty payments by merely increasing the federal fees. We believe that this concern is more apparent than real. Royalties will go up in the event of higher fees only where a buyer has agreed to reimburse the lessee for the higher amounts. In most cases (excepting open-ended reimbursement agreements entered into before the fee increase in question), the buyer's agreement to reimburse the higher fees will reflect his willingness to pay more for the coal. The higher value so placed on the coal is an appropriate basis for an increased royalty. Moreover, excluding these reimbursements from "gross proceeds" would discriminate arbitrarily between lessees who arrange to take a part of the selling price for their coal in the form of such reimbursements and those who do not, and would thereby encourage lessees to negotiate the form of compensation that enables them to avoid incurring royalty obligations. This kind of invitation to royalty avoidance is clearly not in the public's best interest and is not a direction in which we should be moving.

The Minerals Management Service, in their recent solicitation of comments in proposed new coal royalty valuation regulations (January 1,5 987, 52 FR 1840) offered for consideration definitions of value (gross proceeds) which caused us some concern. In addition to proposing to leave out of the definition of proceeds certain payments which we believe should be included as noted above, they appeared to propose a definition which could have included payments that do not represent consideration for coal produced by the lessee and therefore ought not to give rise to a royalty obligation.

Take-or-Pay Payments

A specific example of this potential overinclusiveness is the express inclusion in the definition of the proceeds potentially subject to royalty of "take-or-pay" payments, defined as "any payment received by the lessee under a 'take-or-pay' clause in its sales contracts." At least in most cases, imposing a royalty on take-or-pay payments is inconsistent with the purpose of a royalty, and threatens to lead to unreasonable and unfair results.

A royalty compensates the mineral owner for the depletion of his resource. It has traditionally been based on actual production of the mineral, whereby the coal is severed from the mineral owner's property and becomes the property of the lessee or the purchaser.*/ In contrast, a take-or-pay provision commonly requires the purchaser to pay for coal that has not been produced and remains a part of the lessor's mineral estate. Requiring a lessee to pay a royalty on such a take-or-pay payment gives the mineral owner -- in this case the government -- compensation when it has suffered no loss. In addition, it gives the mineral owner an opportunity to obtain a double royalty -- the first on the take-or-pay payment and the second when the coal is actually produced and sold.

Even where no double royalty is paid, requiring the lessee to pay a royalty on such payments in many cases imposes an unjust burden on the lessee. Most take-or-pay clauses nowadays are not in the classic form, in which the purchaser is simply required to pay for the coal when delivery is scheduled whether or not it accepts delivery. In the classic situation, the lessee receives the full payment called for by the contract and incurs no additional or uncompensated expenses. But typical take-or-pay provisions in contemporary coal contracts are not of this type. Instead, they often have the effect of allowing the purchaser to defer taking the coal for some period of time upon payment of specified amounts to the coal producer. The overriding purpose of such "take-or-pay" payments is to compensate the lessee for the added costs that it incurs as a result of the delay and, in the event ~~that~~ the purchaser does not eventually take the coal, for the uncompensated investment and risk incurred to build and operate the coal mine in order to perform the purchaser's contract. The amount of such take-or-pay payments is not measured by the value of the coal, and their purpose is not to pay the producer for the coal.

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*/ In fact, other provisions of the MMS proposed regulations suggest that, notwithstanding the broad definition of the proceeds subject to royalty, the regulations are not intended to apply to unproduced coal.

These take-or-pay provisions may take a wide variety of different forms. In some cases, the take-or-pay payments are in the nature of carrying charges or liquidated damages to the coal producer, designed to cover the costs of idling the mine, maintaining the producer's lease, and maintaining the capacity to resume production at a later date. If the purchaser eventually takes the coal, he pays the contract price for the coal in addition to the take-or-pay payments. Under those circumstances, there can be no argument that the take-or-pay payments are really payments for the coal. Imposing a royalty on such payments on a coal-producer lessee deprives the lessee of part of the compensation that he has negotiated for the costs imposed on him by the purchaser's failure to perform its contractual obligations.

In other cases, take-or-pay payments may be in the nature of partial payments of the price that will be due for the coal if the purchaser eventually takes it. In these cases, if the purchaser does later take the coal and pays the balance of the purchase price, the initial take-or-pay payments may be reasonably regarded as a payment for the coal. But if the purchaser never takes the coal, the take-or-pay payments serve as compensation for the purchaser's breach of contract and the producer-lessee's unremunerated investment in performing the contract. In that event, it is unjust to the lessee to subject to royalty the amounts that were negotiated in order to compensate him for a lost investment. Whether take-or-pay payments received under provisions of this type are to be considered payments for the coal, or rather compensatory payments for the purchaser's failure to take and pay full value for the coal, cannot be known when the payments are received. Only when and if the purchaser finally takes and makes full payment for the coal is it established that a royalty is properly due.

Thus, to impose royalties on all take-or-pay payments is to include payments that are not consideration for coal and are not appropriately subject to royalty. The mineral owner has no legitimate claim to a royalty in these circumstances. In issuing a lease, it does not obtain any right or expectation that it will receive a royalty on any guaranteed quantity of coal. Unlike the lessee, it takes no risk: if the coal is not produced, it will remain available for sale in the future. And to exact a royalty from the lessee on payments that either clearly are -- or may later be proved to be -- in substance compensatory damages is to deprive the lessee of a portion of the compensation that it contracted for. This result is particularly unfair in the case of contracts negotiated under the old valuation rules, where no one had any idea that a royalty would be due on the negotiated-for payments.

In addition, other kinds of compensatory payments involving compensation for costs and losses other than the value of produced coal might be included in the "expansive" definition of "gross proceeds" contemplated by the Notice. For example, an award of damages for breach of a coal contract may not be based on the value of any coal production, but rather on the extent of the losses incurred by the lessee by reason of the non-production of leased coal. Under an expansive interpretation, such damages might be considered as a form of "reimbursement" within the definition of "gross proceeds," even though they would not be subject to royalty under the Act.

Subjective Valuation Standards

The coal valuation proposal of the MMS also raised another issue worth mentioning. That is the proposal to use a subjective approach to valuation standards for ad valorem leases. The MMS proposal, for example, provides that the value of coal sold pursuant to an arm's-length contract is to be the gross proceeds accruing, or which "could" accrue, to the lessee. Another section provides that value shall be based on the highest price a prudent operator "could" receive under its contract.

UPRC believes that an effort to collect royalties on proceeds that "could" have been received by a lessee would be needlessly burdensome and counterproductive. As the MMS rulemaking notice recognizes, royalty valuation methods yield a reasonable and long-term maximum rate of return for the public when the value is determined by the interaction of competing market forces. The lessee "is going to negotiate the best deal he can to further his own interests, advancing those of the royalty owner as well." 52 Fed. Reg. at 1841. Even where the lessee fails to demand the highest price that could have been obtained for its product, it has presumptively acted in its own self-interest and therefore in the interest of the royalty owner as well. To impose royalties on the greater amounts that the operator "could" have obtained would be shortsighted, because it would deter lessees from making concessions to their customers that appear to be advantageous in the long-run, both to the lessee and, through the lessee, to the Government as lessor.

The one circumstance that might justify seeking to change the established method of royalty determination based on the price actually paid would be evidence of collusion in the coal industry between lessees and their customers to deprive the Government of royalty payments. But the rulemaking notice points to no such evidence, and UPRC does not believe any such evidence exists. Indeed, it is inherently improbable that a lessee would give up its 87 1/2 percent of the additional money that could reasonably have been obtained from a purchaser simply to deny the government its 12 1/2 percent. In the absence of a basis for concern about improper collusion between lessees and purchasers, royalties should not be based upon any amounts not actually realized by a lessee.

The MMS proposal does appear to limit the subjectivity somewhat by indicating that no effort will be made to obtain royalties on amounts that "could" have been obtained by lessees in any case where the lessee enters into a formal contract amendment embodying concessions the lessee has made to its purchasers. While UPRC agrees that such a written contract amendment should be dispositive, it does not believe that a formal amendment should be required in order to avoid royalty obligations based on arguable contract rights that a lessee has chosen not to press to the limit. Requiring formal amendments will destroy the process of informal mutual accommodation in day-to-day contract administration by which many coal producers and their customers maintain viable long-term working relationships under adverse conditions. Contract administrators make decisions daily, even hourly, concerning the interpretation of ambiguous contract provisions, questions of contract administration not foreseen in the contract documents, or new requests made by one or another party in the light of special circumstances. Most of these decisions involve compromises, by one side or the other or by both, of positions that might be taken under a strict interpretation of the contract and that, if litigated, might even prevail. Sometimes there is no compromise, and one party simply decides that it is not in its long-term interest to press a particular point at a particular time. It would be impossible to translate all these informal daily accommodations and decisions into formal contract amendments, and in practice many of them would not be made at all if they had to be vetted by lawyers and cast in formal contract documents.

Where a relationship of mutual accommodation prevails, it does so because both sides have concluded that their long-term interest is served by a spirit of give-and-take rather than by pushing every possible contract position to the extreme and by frequent resort to the courts. The process of accommodation is socially beneficial, it is beneficial to the coal producers, and it is presumptively beneficial to the Government. In the absence of evidence that the process is being abused to the Government's detriment, we see no valid purpose to be served by penalizing accommodation and promoting confrontation through a royalty imposed whenever MMS decides that a particular concession -- whether or not prudent from the lessee's standpoint -- gave up a benefit that arguably could have been obtained under the lessee's sales contract.

Moreover, in situations where the lessee cannot obtain a formal contract amendment, the MMS proposal provides that the lessee must either take "documented" measures "to force purchaser compliance" or else must pay royalty based upon the higher price or benefit. In other words, in cases where there is no written contract revision, the lessee may be forced to litigate every question of contract interpretation that could ever conceivably arise -- if not with the purchaser, then with MMS when it demands the higher royalties that allegedly "could" have been obtained. We can see no justification for such a compromise-defeating, litigation-spawning approach. If MMS truly believes that royalty valuation methods yield the most reasonable returns where value is determined by the interaction of market forces, then MMS should not promulgate regulations that discourage lessees from resolving disputes through arm's-length negotiations with their customers in an informal, amicable, cost-efficient way.

In summary, we believe that royalty should be based on the full value of the compensation received for the coal by the lessee. To value the coal any way other than the full value received is unfair to one party or another. Further, even on issues such as ease of administration, it is hard to imagine how it could be easier to determine value than by utilizing the sales price. It is only when there are non-arm's-length transactions that the price may not reflect the true value of the transaction. These special cases will require unique treatment in any system.

Again, we appreciate this opportunity to provide our comments in the direction coal product valuation rules are or should be moving. We would be pleased to respond to any questions the Committee may have concerning our comments.

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November 30, 1987

The Honorable John Melcher
Chairman, Senate Energy and Commerce
Subcommittee on Mineral Resources
362 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Melcher:

On behalf of the Western Regional Council Coal ad hoc Committee, we appreciate your scheduling a November 16, 1987 hearing of your Subcommittee to review Interior's Mineral Management Service (MMS) coal product valuation proposal.

The Western Regional Council is particularly concerned about the MMS proposal. We are writing to ask that you review the enclosed Western Regional Council testimony and submit it for the formal hearing record of your November 16 hearing.

We thank you for your continuing interest in these issues. Please let us know if we can respond to any questions or provide further information.

Sincerely,

John Hardin dl

John Hardin, Chairman
Coal ad hoc Committee

0104P

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STATEMENT OF THE WESTERN REGIONAL COUNCIL

TO THE SUBCOMMITTEE ON MINERAL RESOURCES

HEARING ON COAL PRODUCT VALUATION

NOVEMBER 16, 1987

The Western Regional Council appreciates this opportunity to provide testimony to the Subcommittee on the Mineral Management Service (MMS) coal product valuation proposal for royalty purposes.

The Western Regional Council and our member companies are very concerned with both the specific, technical content of the proposed rulemaking and the general direction it takes federal mineral valuation, royalty, and related policies and activities. Consequently, the Council is pleased with the Subcommittee's interest in the matter and appreciate this opportunity to provide some of our views and concerns in this testimony.

The Western Regional Council (WRC) is an organization of chief executive officers of 46 companies with significant activities in the Western United States, including mining, financial, utility, forest product, transportation, oil and gas, engineering, accounting and other enterprises. The Council seeks to establish a balance between the need for a safe and clean environment, and a healthy and active economy in our region. Because of the predominance of federal coal reserves in the West and the diverse nature of our membership, the WRC has a particular interest in federal regulations governing the leasing and management of federal coal reserves in our region.

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The latest comment period by MMS on this issue was closed October 13, 1987. The comment period on the pending rulemaking was specifically reopened prior to that deadline to receive additional information on three matters.

The first matter is a coal/electric utility industry proposal to substitute for the proposed rules "royalty values based on the Internal Revenue Code (IRC) concept of 'gross income from property' used for the depletion calculations under IRC Section 613 and implementing regulations."

The second matter is a letter sent to MMS by Governor Sullivan of Wyoming containing comments on the industry proposal.

The third matter is a section-by-section analysis of the original MMS proposal from Indian representatives.

The WRC has long advocated revision of the federal percentage royalty to make it consistent with Congressional intent in the underlying statute. Congress did not intend the economic rent due the government for federal coal to artificially inflate by allowing the percentage royalty to apply to and interact with federal and state excise taxes or by allowing a pure mathematical inflation of the royalty by having the royalty reapply against itself.

In our comments submitted to the MMS earlier this year, the Council reiterated our basic position on royalty calculations and valuation. Focusing on the MMS proposal, we expressed strong concern over the "royalty on royalty" issue, payments under the take-or-pay contract provisions, payments for coal avoidably lost, limits on acceptable transportation and coal beneficiation costs, submission of documentation for MMS review, and arbitrary identification of in-situ and surface gasification and liquefaction operations. We will enclose our comments from the April 14, 1987 submission to the MMS to provide further background on the matter.

Regarding the pending coal/utility industry proposal, we note that it represents the combined efforts of many members of the National Coal Association, Edison Electric Institute, American Mining Congress, American Public Power Association, National Rural Electric Cooperative Association and the Western Fuels Association, Inc. Many of the WRC and our member company interests were involved or reflected in the development of the industry proposal. Consequently, it reflects many of our views and concerns.

The WRC specifically endorses the premise of the industry proposal to base royalty values on the Internal Revenue Code (IRC) concept of gross income from property used for depletion calculations. Its implementation would establish a fixed point for valuation applicable for all coal. It also would provide a benchmark fairly settled by previous experience and litigation.

The industry proposal would also provide the significant benefit of relative simplicity in administration (an advantage clearly not applicable to the pending MMS proposal which would require significant MMS manpower and analysis involving literally hundreds of different contracts or agreements to arrive at a readily disputable figure).

In supporting the basis of the industry proposal, we would suggest some further refinement. Points 7 and 11 under the industry proposal section entitled "Impact on Specific Issues" should be more fully developed. In the Federal Coal Leasing Amendments Act of 1976, Congress intended to levy a royalty on the value of coal actually produced from federal leases. This means the intrinsic value of the coal at the point of extraction from the ground. Congress did not foresee the evolution of an accounting mechanism where certain royalties, fees, or taxes would be included in the base from which other royalties or taxes would be calculated.

The implementing regulations have since evolved from the original Congressional intent of up to 12 1/2% of value to 12 1/2% of gross value, then gross proceeds, and now gross realization. In its calculations, the Department of Interior now may include original owner override fees, state and local severance and similar taxes, federal black lung taxes, the Surface Mining Control and Reclamation Act (SMCRA) fees, and the federal royalty itself. Calculating the royalty on value plus these assessments is not a tax on the "value" of the coal as defined by statute, but is instead a royalty on the assessments plus the value of the coal. Therefore, the calculation can result in an effective royalty rate of 21.8% of the value of the coal at the time it is produced, which is nearly double the statutory rate of 12.5%.

The Western Regional Council has continually contended the percentage royalty should be applied only against the non-tax, non-royalty portion of the price--i.e. the portion of the price the seller receives as reimbursement for the cost of production plus a profit.

The MMS seems to acknowledge this through the elimination of black lung taxes and reclamation fees from the definition of gross proceeds in this rulemaking. The WRC appreciates and endorses the position of the MMS to exclude the SMCRA and black lung assessments from the definition of gross proceeds. Such additional costs as other similar taxes and fees, state severance taxes, etc., should also be excluded.

These comments are also applicable to the letter submitted by Governor Sullivan of Wyoming.

Regarding the section-by-section analysis submitted by Indian representatives, under 206.25 on page 8 of their comments, they address "coal lost in stockpile." WRC holds that no royalty should accrue to coal that cannot be produced and sold at a profit. Therefore, "coal lost in stockpile but not sold," should not be subject to royalty.

In conclusion, we would like to reiterate our support for the philosophy of coal royalty valuation incorporated in the pending industry proposal. We applaud its simplicity and workability. We urge the Mineral Resources Subcommittee, the Minerals Management Service and the Department of Interior to be responsive to that proposal and our views and concerns.

Thank you again for the opportunity to offer our testimony in written form for inclusion in the November 16 hearing record.

0102P

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April 14, 1987

Mr. Dennis C. Whitcomb
Minerals Management Service
Royalty Management Program
Rules and Procedures Branch
Denver Federal Center, Building 65
P.O. Box 25165
Mail Stop 660
Denver, Colorado 80225

Dear Mr. Whitcomb:

The Minerals Management Service (MMS) of the Department of Interior published in the Federal Register, Volume 52, No. 10, on Thursday, January 15, 1987, beginning at page 1840, a Notice of Proposed Rulemaking. The Proposed Rulemaking is intended to "provide for the amendment and clarification of regulations governing the valuation of coal for royalty purposes." The Western Regional Council appreciates the opportunity to submit comments on the Proposed Rulemaking.

The Western Regional Council (WRC) is an organization of the Chief Executive Officers of 46 companies with significant activities in the Western United States, including mining, financial, utility, forest product, transportation, oil and gas, engineering, accounting and other enterprises. The Council seeks to establish a balance between the need for a safe and clean environment and a healthy and active economy in our region.

Administration and management of the federal coal leasing and management program is of particular interest to the WRC and its member companies for at least two significant reasons. First, the federal government has dominant ownership and control of coal reserves in the West. Federal coal lands contain about 60 percent of the total western coal reserve base, and the federal government also indirectly controls the use of at least an additional

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20 percent of the coal in the West. Consequently, approximately 80 percent of western coal lands are under federal control.

Second, the WRC includes a diverse membership affected in different ways by federal coal leasing and management policies. WRC members include lessees of federal coal; lessors and lessees of private coal; coal producers, transporters and consumers; and companies and individuals impacted as coal-generated power users.

The Western Regional Council's comments on the Proposed Rulemaking follow.

1. The Federal Coal Leasing Amendments Act of 1976 provided for major changes in the royalty structure for the production and sale of federally owned coal. All federal coal leases issued or renewed subsequent to that Act "shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12-1/2 percentum of the value of coal as defined by regulation," except that a lesser amount may be established for underground coal. The introduction of percentage royalty represented a quantum increase in royalty costs for federal coal producers and their customers. It is important that the increase in royalty costs due to the percentage royalties be limited to the intent of Congress in establishing those new royalties.

The implementing regulations provided that the royalty calculation will normally be made on the basis of "gross value at the point of sale." This phrase has been misinterpreted by the Department to include state and local severance and similar taxes, federal black lung taxes, the Surface Mining Control and Reclamation Act (SMCRA) reclamation fees, and even the federal royalty itself. Calculating the royalty on value plus these assessments is not a tax on the "value" of the coal as defined by statute, but is instead a royalty on the assessments plus the value of the coal. Therefore, the calculation can result in an effective royalty rate of 21.8% of the value of the coal at the time it is produced, which is nearly double the statutory rate of 12-1/2%.

The Western Regional Council has long contended that the percentage royalty should be applied only against the non-tax, non-royalty portion of the price --i.e. the portion of the price the seller receives as reimbursement for the cost of production plus a profit. (Attached is an issue brief on "Federal Percentage Royalties" submitted to the Department by the Council in 1983.)

Congress did not intend the economic rent due the government for federal coal to artificially inflate by allowing the percentage royalty to apply to and interact with federal and state excise taxes or by allowing a pure mathematical inflation of the royalty by having the royalty reapply against itself. The Minerals Management Service seems to acknowledge this through the elimination of black lung taxes and reclamation fees from the definition of gross proceeds in this rulemaking. The WRC appreciates and endorses the MMS proposal to exclude the SMCRA and black lung assessments from the definition of gross proceeds. However, we feel such additional costs as other similar taxes and fees, state severance taxes, etc., should also be excluded from the gross proceeds definition.

2. Payments under the take-or-pay contract provisions should not be considered part of gross proceeds for royalty purposes. Take-or-pay serves only as a mechanism for covering a producer's investment risk and maintaining production capacity for the benefit of the customer. Since coal is not produced under take-or-pay, the lessor's in-the-ground property values are not diminished. Therefore, royalty imposed on these types of payments would only serve as an added noncompetitive burden on federal coal producers compared to non-federal coal producers. This provision is ill-conceived and should not be implemented.

Actual production, including severance and sale, should be required before a royalty is assessed. The royalty should be applied against production and not, as previously noted, against contract provisions such as take-or-pay. In addition, royalty should not be applied to other forms of compensation such as court awards in the case of default or breach of contract.

3. The proposed rulemaking should not include payments for coal avoidably lost. The BLM's Maximum Economic Recovery regulations already serve to define how the reserve will be produced. If in the course of mining, the marketplace will not economically support producing certain seams or areas, the operator should not be penalized. No royalty should accrue to coal that can't be produced and sold profitably.

4. The proposed rulemaking would set unreasonable and inappropriate limits on acceptable transportation and coal beneficiation costs and be harmful to both the federal government and its lessees. These items, along with production costs and profit define the overall marketability of the coal. For MMS to arbitrarily set limits on which costs in excess of the threshold can be fully allocated toward the costs of production and delivery in order to boost federal royalty income simply serves to geographically shrink the market for federal coal while creating unnecessary, competitive inequities for federal coal producers.

5. The WRC opposes the proposal that all sales and other contracts affecting the gross proceeds determination be submitted, upon request, to MMS for review. This concept represents unnecessary involvement and may lead to a breach of confidentiality by the government. MMS has a legitimate interest in these contracts and should be provided an opportunity to conduct audits under certain conditions. However, compiling and maintaining in-house files on all such contracts is inappropriate given the sensitive and economically valuable nature of such information and the potential for abuse.

6. The WRC opposes section 206.264 of the proposed rulemaking regarding in-situ and surface gasification and liquefaction operations. The section arbitrarily identifies in-situ and surface gasification and liquefaction operations, excluding other technologies. It also leaves full discretion to MMS for determining value of production for the purpose of computing the royalty. It would be more appropriate to delete this section, place it in a reserved category and reconsider it in the future.

There are numerous other issues within the proposal of concern to the Council. We reference the comments of individual producers and other organizations of coal producers. In general, we believe MMS has not justified the need for a complete overhaul of the system. Instead, MMS should withdraw this proposed rulemaking and conduct a full economic and regulatory impact assessment to ascertain the impact of adopting and administering such a proposal.

We appreciate this opportunity to comment and will be pleased to provide further comments or information to clarify these views.

Yours truly,

John Hardin ad

John Hardin, Chairman
Coal ad hoc Committee

JH/ad1307L

STATEMENT OF THE
WESTERN COAL TRAFFIC LEAGUE

FOR

OVERSIGHT HEARING ON
PROPOSED COAL PRODUCT VALUATION RULES

BEFORE

SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION
OF THE
SENATE COMMITTEE ON
ENERGY & NATURAL RESOURCES

WASHINGTON, D.C.

November, 1987

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STATEMENT OF THE
WESTERN COAL TRAFFIC LEAGUE

FOR

OVERSIGHT HEARING ON
PROPOSED COAL PRODUCT VALUATION RULES

BEFORE

SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION
OF THE
SENATE COMMITTEE ON
ENERGY & NATURAL RESOURCES

The Western Coal Traffic League ("WCTL") presents this statement for the record being prepared in connection with the Subcommittee's oversight hearing on the Mineral Management Service's ("MMS") notice of proposed rulemaking entitled Revision of Coal Product Valuation Regulations and Related Topics ("Proposed Regulations"), published in the January 15, 1987 Federal Register. 52 Fed. Reg. 1840-56 (1987).

SUMMARY

WCTL, a voluntary association formed in 1976, represents the interests of its members before agencies of the federal government in matters related to the acquisition and transportation of bituminous coal. Its members are identified in Attachment No. 1 to this statement.

The members of WCTL are major consumers of bituminous coal mined west of the Mississippi River. They obtain a substantial part of their coal supplies from producers holding federal coal leases. The prices WCTL members are charged for their coal must, of course, cover the lease royalties that their suppliers pay to the Department of the Interior ("DOI"). Moreover, the long-term coal supply contracts WCTL members have entered into permit their suppliers to pass through any increases in federal coal royalties. These increases must in turn be passed through by WCTL members to their customers in the form of higher electric bills. Thus, WCTL represents the interests of the consumers who pay the federal royalties.

WCTL believes that DOI's existing and proposed royalty valuation regulations fail to take into account the interests of those individuals who ultimately pay the federal coal royalties -- electric utility customers. Current and proposed regulations have only one goal -- "revenue maximization." This policy interest is generally supported by most coal producing states because fifty percent of the federal coal royalty revenues are directly returned to these states. However, DOI and MMS are required by law to consider not only the interests of revenue collecting states, but also the interests of the public who pay the bills. This is particularly true because the same consumers who pay federal royalties already pay enormous returns to the producing states via the various and numerous state taxes on coal production.

Consistent with Congress' intent to produce a fair and equitable federal coal royalty policy, DOI should:

- Deduct all federal, state, and local taxes from the royalty base;
- Not assess royalties on "take-or-pay" payments;
- Eliminate "prudent operator" valuation standards; and
- Adopt the coal industry/utility industry valuation proposals

WCTL presents this statement in support of these positions.

I.

THE STATUTORY AND REGULATORY SCHEME

The Proposed Regulations establish standards to determine "the valuation of coal for royalty purposes." Id. at 1840. When adopted, these standards will "revise the current regulations regarding the valuation of coal . . . ." Id.

A. THE EXISTING REGULATORY STANDARDS

MMS's statutory authority to conduct its valuation proceeding arises under Section 7 of the Mineral Lands Leasing Act of 1920, as amended by Section 6 of the Federal Lands Leasing

Act of 1976. Section 7 of the Mineral Lands Leasing Act of 1920 allowed the Department of the Interior ("DOI") to prescribe a royalty lease rate, subject to a minimum of $0.05 per ton. These royalty rates were subject to readjustment at twenty (20) year intervals. FCLAA amended Section 7 royalty standards by establishing minimum royalty rates equal to 12.5 percent of the "value" of federal coal, subject to readjustment at ten (10) year intervals. DOI was given the authority to define the "value" of coal.

Section 7, as amended, is codified at 30 U.S.C. § 207 and provides in pertinent part:

> § 207. Conditions of lease
>
> (a) Term of lease; annual rentals; royalties; readjustment of conditions
>
> A coal lease shall be for a term of twenty years and for so long thereafter as coal is produced annually in commercial quantities from that lease. Any lease which is not producing in commercial quantities at the end of ten years shall be terminated. The Secretary shall by regulation prescribe annual rentals on leases. A lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12½ per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations. The lease shall include such other terms and conditions as the Secretary shall determine. Such rentals and royalties and other terms and conditions of the lease will be subject to readjustment at the end of its primary term of twenty years and at the end

> of each ten-year period thereafter if the lease is extended.

30 U.S.C. § 207 (1986).

DOI's current regulations governing coal valuation are codified at 30 C.F.R. § 203.200 and 43 C.F.R. § 3482. Pursuant to these standards, coal is valued at "the unit sale or contract price times the number of units sold . . . ." 30 C.F.R. § 203.200(g) (1985).[1] MMS has traditionally deducted costs incurred in washing and transporting coal in determining "contract price" under these regulations. See Proposed Regulations at 1844.

DOI's current regulations also establish the minimum surface mine royalty rate contained in FCLAA -- 12.5 percent of coal value -- that shall automatically apply when pre-FCLAA leases are readjusted. 43 C.F.R. § 3451.1(a)(2) (1986). The regulations state:

> Any lease subject to readjustment which contains a royalty rate less than the minimum royalty prescribed in [FCLAA] . . . shall be readjusted to conform to the minimum prescribed in that section.

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[1] Other standards are utilized if MMS determines the contract price is not part of "a bona fide transaction." 30 C.F.R. § 203.200(g)(1) (1985).

Id.[2/]

Thus, under DOI regulations, all post-FCLAA leases apply royalty rates of 12.5 percent to the "value" of surface-mined coal as defined at 30 C.F.R. § 203.200(g). The same royalty rates are also applied automatically to all pre-FCLAA leases upon readjustment. 43 C.F.R. § 3451.1 (1986).

Section 39 of the Minerals Lands Leasing Act of 1920, now codified at 30 U.S.C. § 209, gives DOI the authority to reduce royalties in certain instances:

> The Secretary of the Interior, for the purpose of encouraging the greatest ultimate recovery of coal . . . and in the interest of conservation of natural resources, is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on any tract or portion thereof segregated for royalty purposes, whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein.

30 U.S.C. § 209 (1986).

DOI has adopted regulations to implement Section 39. See Royalty Rate Reduction Guidelines for The Solid Leasable

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[2/] 43 C.F.R. § 3451.1 also establishes adjustment notification and protest procedures.

Minerals, (Decision served June 26, 1987). Under these regulations, DOI will consider reduction requests where, inter alia, a coal company is operating at a loss, or where the royalty makes coal sales non-competitive. Reductions would not be permitted where coal lessors could pass-on royalties to their customers.

B. THE PROPOSED REGULATIONS

The Proposed Regulations establish coal value in arms-length ad valorem leases as equalling the "gross proceeds" received by a coal lessee. Proposed Regulations at 1851. "Gross proceeds" include "[all] consideration paid to a coal lessee," id. at 1849, for coal production as well as consideration received that is unrelated to production (e.g., monies collected by lessees as liquidated damages when a purchaser fails to meet minimum purchase obligations -- so-called "take-or-pay" payments). Id. All tax payments collected by the lessee are also included as part of "gross proceeds" with two exceptions: federal black lung taxes and abandoned mine lands fees. Id. MMS also reserves the right to value coal in excess of "gross proceeds" if, in MMS's view, the "gross proceeds" collected are less than "the highest price a prudent operator could receive under its contract." Id. at 1852.

Two "allowances" from gross proceeds are proposed: a "coal washing allowance" and a "transportation allowance." The coal washing allowance "allow[s] a deduction in determining value for royalty purposes for the reasonable, actual costs incurred to wash coal . . . ." Id. The transportation allowance "allow[s] a deduction in determining value for royalty purposes for the reasonable, actual costs incurred to . . . [t]ransport the coal" in specified instances where transportation costs are included on the gross receipts collected by the lessee. Id. at 1854. In the absence of express approval from MMS, the transportation allowance may not exceed 50 percent of coal value, and the combined transportation/washing allowances may not exceed 75 percent of coal value.

In situations where coal sales agreements are not "arms-length," value will be determined by the use of the first of the following five designated criteria that can be applied. The criteria are: (1) gross proceeds under the lease, if gross proceeds are equivalent to the lessee's comparable arms-length contract receipts in the area; (2) gross proceeds under the lease, if the gross proceeds are equivalent to other lessees' comparable arms-length contract receipts in the area; (3) prices reported for comparable coal to the Department of Energy; (4) other published prices; or (5) any other reasonable valuation method. Id. at 1851-52. Special rules also apply for determining transportation and washing allowances for non-arms-length contracts. Id. at 1853, 1855.

C. DISPOSITION OF ROYALTY PROCEEDS

Federal statutes govern the disposition of collected royalties. Initially, all amounts collected are paid into the Treasury of the United States. 30 U.S.C. § 191 (1986). Fifty percent of the sums collected are then returned to the states where royalty production occurred. Id. Forty percent is paid into a fund created by the Reclamation Act of 1902. Id.[3] Ten percent of the money is retained by the Treasury. Id. Regulations establishing specific payment procedures are codified at 30 C.F.R. § 219 (1985).

II.

DOI'S CURRENT INTERPRETATION AND ADMINISTRATION OF THE STATUTORY SCHEME IS PRODUCING MASSIVE PRICE INCREASES FOR CONSUMERS AND SHORT-TERM WINDFALLS FOR COAL PRODUCING STATES

DOI's current administration of the Mineral Leasing Act will produce massive increases in royalty revenues. These increases will be paid by the customers of federal coal lessees -- the nation's electric utility customers. Fifty percent of these windfalls will be returned directly to producer states that already have exacted enormous sums from out-of-state electric utility ratepayers via a variety of state and local taxes.

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[3] See 43 U.S.C. § 391 (1986). The Reclamation Act created a fund to finance irrigation and water projects in designated western states. Id.

A. THE MASSIVE INCREASE IN ROYALTY PAYMENTS

The massive increases in federal royalty payments arise due to the interaction of two DOI actions: (1) its lease readjustment policies, and (2) its definition of "value" for royalty purposes.

A substantial share of the coal now being produced on federal lands is mined under leases issued by the federal government prior to 1976.[4] Most of these leases contained royalties established at a specified cents-per-ton rate. The customary average cents-per-ton royalty rate on surface mined coal is 17½ cents. DOI, Mineral Revenues, the 1985 Report on Receipts From Federal and Indian Leases at 87 (1986).

The FCLAA was enacted in 1976. DOI takes the position that pre-1976 lease rates must automatically be adjusted to FCLAA levels (12.5 percent of the "value" of coal) when the pre-1976 leases come up for readjustment. This policy is codified in DOI regulations (43 C.F.R. § 3451.1(a)(2), supra) and in numerous DOI decisions. See, e.g., Whether Leases Adjusted Prior To August 4, 1976, Subject To Readjustment After That Date Must Be Readjusted To Conform To The Federal Coal Leasing Amendments Act Of 1976, 88 I.D. 1003 (1981).[5] Thus, as leases are readjusted, the pre-FCLAA rates are being changed to equal the post-FCLAA rates of 12.5 percent of the "value" of the coal. As described above, DOI regulations equate the value of coal with its sales price.

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[4] A 1986 Office of Technology Assessment report found that 189 pre-FCLAA leases would produce coal in commercial quantities in 1986. These leases contain over 8.3 billion tons of coal. OTA Special Report, Potential Effects of Section 3 of the Federal Coal Leasing Amendments Act of 1976 at 46 (1986).

The impact of these two administration actions is self-evident. Assume that a coal lessee under a pre-FCLAA lease is selling coal at $25.20 per ton under a long-term cost pass-through contract, with a royalty charge of $0.20 per ton. When the lease is readjusted, the new price equals $28.57, and the new royalty equals $3.57 per ton ($28.57 x .125) -- an increase, in the royalty of more than 1780 percent.

Increases of 1,000 to 2,000 percent in coal royalty charges are now commonplace as pre-1976 leases are readjusted. Under this program, MMS will raise hundreds of millions of dollars in increased federal coal royalties annually. As DOI itself acknowledges, "[w]ith the significant increase in readjustments, the royalty impact of this high priority BLM activity will dramatically increase." DOI, Federal Coal Management Report for Fiscal Year 1985 at 18 (emphasis added).

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[5] The validity of DOI's position is the object of numerous lawsuits.

B. CONSUMERS PAY THE ROYALTIES

MMS collects federal royalty payments from coal lessees -- typically coal producers. The producers, in turn, recoup the royalties from their customers -- who usually are electric utilities utilizing coal as a boiler fuel. The utilities, like the coal producers, pass-on the royalty charge to their customers -- the electric utility ratepayers.

Electric utility ratepayers are bearing the brunt of DOI's royalty policies. WCTL estimates that royalties paid by its members will increase by over $50 million annually upon the completion of the pre-FCLAA lease adjustment process. Overall, utilities can expect annual royalty increases of over $200 million per year by the mid-1990's.[6/]

The following chart provides a graphic example of the impact of royalty increases on electric utilities:

[6/] See RDI, Inc., The Economic and Market Impacts of Rising Federal Coal Royalty Rates at 1-2 (Nov. 1987) ("RDI Study").

IMPACT OF ROYALTY INCREASES

Utility	Projected Annual Increase In Royalty Charges
Central Power & Light Co. (Corpus Christi, Texas)	$ 4,800,000
Kansas City Power & Light Co. (Kansas City, Missouri)	$ 2,100,000
TUCO, Inc. (Amarillo, Texas)	$ 8,500,000
City of Colorado Springs (Colorado Springs, Colorado)	$ 2,500,000
Central Louisiana Electric Co. (Pineville, Louisiana)	$ 2,700,000

On an industry-wide basis, DOI royalty administration will require the nation's electric customers to pay hundreds of millions of dollars in increased royalties per year.

C. PRODUCING STATES REAP WINDFALL PROFITS

Fifty percent of the royalties collected by MMS are returned directly to producing states. 30 U.S.C. § 191, supra. In effect, DOI and MMS are administering a program that takes monies from coal consuming states (including Texas, Minnesota, Louisiana, etc.) and transfers it to coal producing states (including Wyoming, Montana, and Colorado). Thus, most of the billion dollar (+) increase in federal coal royalties will wind up in the coffers of a few states.

Coal producing states already collect enormous sums from electric utility customers via the many state and local taxes they assess on coal production. Severance taxes alone -- just one of the many taxes collected by most producing states -- produce astronomical returns to coal producing states. In 1985, for example, the State of Montana collected $91 million in coal severance taxes, and the State of Wyoming collected $125 million. U.S. Dep't of Commerce, State Government Tax Collections in 1985, Table 9 (1985). Over the period between 1976 and 1985, the States of Wyoming and Montana have collected a combined total of over $1.2 billion in severance taxes.[7/]

State severance taxes are already at levels that commentators find "unprecedented:"

> [S]ince 1971 the coal-producing states have increased their severance taxes to unprecedented levels, bringing about a tremendous transfer of money from the coal-consuming states to the coal-producing states.

The Incomplete Complete Auto Transit Test: Commerce Clause Analysis in Commonwealth Edison Co. v. Montana, 8 Colum. J. Envtl. L. 185, 186 (1982) (emphasis added). Severance taxes are so high that legislation has been proposed in each of the last three

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[7/] The State of Montana collected $619,412,000 during this period, and the State of Wyoming collected $618,334,000. See State Government Tax Collections, Table 9, supra.

sessions of Congress calling for reductions in these tax levels. See, e.g., Limitation of Coal Severance Taxes, H.R. Rep. No. 96-1527, Part 1, 96th Cong., 2d Sess. (1980).

Severance taxes, by themselves, "are many times higher than necessary to cover state direct and indirect costs to support coal production." Id. at 4. Nevertheless, severance taxes are just one of the many taxes states impose on coal production. For example, in 1986, Minnesota Power paid the State of Montana not only $5,304,746 in severance taxes (on 2,940,669 tons), but also a "gross proceeds" tax of $905,854, and a "resource indemnification" tax of $65,207.

Thus, even without any federal tax dollars, principal coal producing states are earning "unprecedented" returns from coal purchasers. DOI valuation policies, if not altered, will require electric ratepayers to pay hundreds of millions in additional sums to producing states that are already earning windfalls through their state and local tax collections.

III.

DOI MUST TAKE INTO ACCOUNT THE CONSUMER INTEREST IN FORMULATING COAL VALUATION REGULATIONS

The stated purpose of the Proposed Regulations is to establish valuation methods that yield a "long-term maximum rate of return for both Federal and Indian leases" and "assure maximum, long-term revenues to all parties concerned." Proposed Regulations, 52 Fed. Reg. at 1841. MMS's exclusive focus on "revenue maximization" is contrary to Congressional intent.

A. DOI MUST CONSIDER THE PUBLIC INTEREST

The Proposed Regulations are issued pursuant to DOI's statutory authority under the Mineral Leasing Act of 1920. Under this Act, DOI is required to value minerals to produce a reasonable return to the public. As observed by the United States Court of Appeals for the District of Columbia Circuit:

> The purpose of the Mineral Leasing Act was not to obtain sales . . . on Government land at any price. The Act was intended to promote wise development of these natural resources and to obtain for the public a reasonable financial return on assets that 'belong' to the public. The Secretary of the Interior is the statutory guardian of this public interest.

California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961) (footnote omitted).

To determine what is a "reasonable" return, DOI must balance the interests of the beneficiaries of coal royalties -- the producing states -- with the interests of those who pay the royalties -- electric ratepayers. This need for a balancing of payor/payee interests has been recognized from the outset of the post-OPEC development of federal coal lands. As stated by DOI Assistant Secretary Martin to a House Subcommittee in 1977:

> The United States Government, because it does happen to own substantial reserves of coal, is in a unique position to set the example for the kind of responsible development that President Carter and the Congress have demanded of all coal owners. We can see that it is mined and burned with respect for workers, their communities, and the environment. And we can prove that socially responsible coal development can be done in a way that satisfies the economic rights of the owners of the coal -- the people of the United States -- *without imposing undue economic burdens on the people who have to pay the bills for the power made from our coal.* If that sound ambitious, it's no more than is expected of any private coal producer in our economic and regulatory system. To ask less of the government would mean that producers of power derived from Federal coal would meet fewer social and economic obligations than those met by companies that depend on privately owned coal.

National Energy Policy, Pt. 4, Hearings Before The House Subcomm. on Energy and Power of the Comm. on Interstate and Foreign Commerce on H.R. 6831, et al., Ser. No. 95-25, 95th Cong., 1st Sess. 11 (1975) (Testimony of Hon. Guy R. Martin, Ass't. Sec. of the Interior for Land and Water Resources) (emphasis added).

It is particularly incumbent on DOI to consider the financial impact of its coal valuation proposals because of the federal government's coal monopoly. Prior to the OPEC Oil Embargo, there was a very small market for federal coal. However, working together, the coal industry, the electric utility industry and the Federal Government created a huge new market for federal coals -- particularly low sulfur coals available in Wyoming, Montana, Colorado and other western states.

After the initial 1973 OPEC oil shocks, the federal government committed our nation to end the "energy crisis." Presidents Ford and Carter called upon Congress to treat the OPEC threat as the "moral equivalent of war" and enact remedial legislation. Congress determined that one of the best ways to break the OPEC Cartel's hold over domestic energy prices was to increase use of domestic energy resources -- principally coal and nuclear power. It then enacted a series of laws encouraging electric utilities, and other large energy consumers, to use coal and other alternative fuels as substitutes for oil and natural gas.[8]

The utility industry responded to Congress' energy directives. Utilities that never used coal undertook the massive capital expenditures needed to build coal-fired electric generating facilities. Thus, utilities like the City Public Service Board of San Antonio, the City of Colorado Springs, Houston Lighting and Power Company and many others that used no coal before the OPEC Embargo became some of the largest coal purchasers in the country.

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[8] *See*, *e.g.*, *Emergency Petroleum Allocation Act of 1973* (Pub. L. 93-511, 88 Stat. 1608); *Federal Nonnuclear Energy Research and Development Act of 1974* (Pub. L. 93-577, 88 Stat. 1878); *Energy Reorganization Act of 1974* (Pub. L. 94-438, 88 Stat. 1233); *Energy Supply and Environmental Coordination Act of 1974* (Pub. L. 93-319, 88 Stat. 246); *Energy Policy and Conservation Act* (Pub. L. 94-163, 89 Stat. 871); *Energy Conservation and Production Act* (Pub. L. 94-385, 90 Stat. 1125); and *Powerplant and Industrial Fuel Use Act* (Pub. L. 95-620, 92 Stat. 246).

The coal needed by the utilities to comply with federal energy (and environmental) directives was low-sulfur coal. This coal is principally located on federal lands in Wyoming, Montana, Colorado, New Mexico and other western states. Development of these lands required massive capital expenditures. Coal companies -- while eager to mine western coal -- were very concerned about the level of risk associated with the large capital requirements. Their lenders shared similar concerns. In order to make the investments, coal companies (and their bankers) insisted that utilities enter into long-term contracts for the purchase of western coal. These contracts gave the mining companies financial security, and also gave utilities a guaranteed coal source for their new plants -- security that was frequently demanded by utility regulators and financiers.

The typical western coal long-term contract calls for coal purchases over a ten to thirty year period. A "base price" for coal is usually set forth, with the base subject to periodic adjustment according to specified formulas. Included in the escalation provisions is a "government regulations" cost pass-through clause. These provisions pass government tax increases through to the customer. The coal industry required these clauses in the post-OPEC long-term coal supply contracts to protect the profit-margin incorporated into the agreements.

At the time these long-term contracts were executed, the federal government charged coal royalties in the $0.15 to $0.25 per ton range. Through the express terms of its coal leases, the federal government promised that when the leases were readjusted, "reasonable" new royalty levels would be assessed. Now, through DOI, the government is breaking its commitments to the electric utility industry. Having become captive to federal coal at the express request, and urgent need, of the government in the 1970s -- and told that royalty charges would be "reasonable" -- the government has changed its position and proposed royalty standards designed solely to "maximize revenues."

Thus, utilities now find the DOI going back on its word that it would not "[impose] undue economic burdens on the people who have to pay the bills for the power made from our coal." National Energy Policy Hearings, supra.

The federal government urged utilities to convert to western coal. The government also promised it would not exact economic penalties from these utilities. Now, DOI is breaking the government's past promises. These actions are unfair to electric ratepayers, and contrary to the public interests DOI is charged with furthering.

B. CONGRESS DID NOT INTEND THAT UTILITY RATE PAYERS PAY MASSIVE ROYALTY INCREASES

Electric ratepayers are subject to multi-million dollar increases in federal royalties. These increases are due to DOI's administration of FCLAA -- *i.e.*, automatically applying the 12.5% of value standard to pre-FCLAA leases, and defining value under a "sales price" or "gross proceeds" standard. A review of the legislative history of FCLAA demonstrates that Congress did not intend that electric ratepayers -- who funded the nation's conversion to coal at a critical hour -- pay huge royalty increases to producing states.

FCLAA was one of many pieces of legislation enacted in response to the energy crisis. The purpose of FCLAA was to promote the increased use of federal coal as a substitute for oil and gas. As stated by the Senate Interior Committee:

> The Committee believes that the purpose of leasing federal coal is to have that coal produced to meet the nation's energy needs.

Federal Coal Leasing Amendments Act of 1975, S. Rep. No. 94-296, 94th Cong., 1st Sess. 15 (1975) ("*Senate Report*"). FCLAA responded to these concerns through various provisions designed to stimulate federal coal leasing and production.

Congress also intended that new post-OPEC coal leases provide a "fair return to the public," *Federal Coal Leasing Amendments Act of 1975*, H.R. Rep. No. 94-681, 94th Cong., 1st Sess. at 17, *reprinted in* 1976 *U.S. Code Cong. & Admin. News* 1953 ("*House Report*"). The Interior Committee Report observed that during the past half-century, the federal government earned only 12.5 cents/ton in coal royalties ($23,373,920 collections on 189,099,653 tons):

> The fact that the minimum royalty and rental established in the law (royalty-5 cents/ton; rental-$.25/acre-1st yr, $.50/acre for the 2nd to 5th years and $1.00/acre thereafter) also contributes to the lack of fair return to the public. According to the Council on Economic Priorities, the Federal government has collected a total of $23,373,920 in royalty payments in the last 54 years, from a total production of 189,099,653 tons of coal. This represents an average royalty of 12.5¢ per ton. The study points out that although royalty rates have increased 75 percent in the last half century, the price of a ton of coal has more than doubled. Thus, the actual royalty being paid is a smaller percentage of the value of the coal now than it was in 1920.

Id. at 18, 1976 *U.S. Code Cong. & Admin. News* at 1953-54. To obtain a "fair return," Congress increased the minimum federal royalty from 5 cents per ton to 12.5% of the value of coal "on all *new leases* except for underground mines."[9] *Id.* at 18, 1976 *U.S. Code Cong. & Admin. News* at 1954 (emphasis added).

While Congress intended that there be *some* increases for new post-FCLAA lease rates, it clearly did not intend that there be massive royalty hikes on pre-FCLAA leases. The *House Report* concluded that increases in royalty collections contemplated by Congress "will have virtually no inflationary impact on the U.S. economy . . . ." *Id.* at 26, 1976 *U.S. Code Cong. & Admin. News* at 1963. Similarly, supporters of FCLAA from coal producing states maintained that "[t]his leasing reform will not significantly increase the price of coal,"[10] and would produce returns to states like Wyoming in the neighborhood of "$10 or $11 million annually . . . ."[11]

DOI's interpretation of FCLAA does "significantly increase the price of coal," will produce "inflationary impacts," and will generate revenues far in excess of "$10 or $11 million annually" to states like Wyoming. Indeed, under DOI's present views, WCTL members will pay, in just over one year's time, an amount nearly double the $23 million the government collected on 189 million tons of production over a 54 year period! This is not the "fair return" contemplated by Congress: it is an extortionate one.

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[9] DOI takes the position that existing pre-FCLAA leases which are readjusted become "new" leases. *See Whether Leases Adjusted Prior To August 4, 1976, Subject To Readjustment After That Date Must Be Readjusted To Conform To The Federal Coal Leasing Amendments Act Of 1976*, *supra*, 88 I.D. at 1008-09.

[10] 122 Cong. Rec. 25463 (Aug. 4, 1976) (statement of Cong. Baucus).

[11] 122 Cong. Rec. 25208 (Aug. 3, 1976) (statement of Sen. McGee).

Moreover, at the time FCLAA was enacted, Congress was enacting an entire legislative program designed to promote utility use of coal by, inter alia, removing financial impediments to increased coal use. There is no legislative support for an administrative program that increases federal coal royalties in the neighborhood of $2.00 to $4.00 per ton.

C. MMS SHOULD REVISE ITS PROPOSED REGULATIONS TO REDUCE THEIR ADVERSE FINANCIAL IMPACT ON ELECTRIC UTILITY RATEPAYERS

In their present form, MMS's current regulations produce, and the Proposed Regulations will continue to produce, huge royalty increases. These increases are contrary to the public interest and Congressional intent. Given DOI's interpretation that FCLAA standards automatically apply to readjusted pre-FCLAA leases, the only way DOI and MMS can produce fair results is by adopting coal "value" regulations that produce fair results not only for producing states, but also for utilities and consumers who pay the royalties.[12]

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[12] WCTL also supports Congressional action to lower the FCLAA royalty rates and/or to provide a phase-in of the rate.

IV.

NEEDED REVISIONS TO DOI'S PROPOSED REGULATIONS

WCTL believes the following changes should be made in the Proposed Regulations: (1) federal, state and local taxes should not be subject to federal coal royalties; (2) royalties should not be assessed on "take-or-pay" payments, or other charges unrelated to production; (3) MMS should not "second-guess" the coal charges being assessed under arms' length coal supply agreements; and, (4) washing and transportation allowances should not be "capped." With these changes, the Proposed Regulations will produce results that are fair to both producing states and electric utility ratepayers.

A. ALL TAXES SHOULD BE EXCLUDED FROM THE ROYALTY PRICE BASE

Under current DOI regulations, royalties are assessed against the entire sales price (including all federal, state, and local taxes). Unquestionably, the federal coal royalty becomes a tax on a tax. The Proposed Regulations continue this practice with one exception: black lung and abandoned mine taxes will not be subject to federal coal royalties.

The "tax on a tax" issue has arisen in many *ad valorem* tax contexts. As a general rule, courts will not sanction a "tax on a tax" unless there is clear and substantial evidence that this result was intended by the legislature. As stated by one New York appellate court:

> While it may not be successfully contended that the Legislature lacks the power to impose, or to delegate to a municipality power to impose, what is called "double taxation," such intention on the part of the Legislature must be clearly and distinctly expressed, it may not be inferred, and every presumption is against it. In re Cooley's Estate, 186 N.Y. 220, 78 N.E. 939, 10 L.R.A.(N.S.) 1010; Tennessee v. Whitworth, 117 U.S. 129, 6 S.Ct. 645, 29 L.Ed. 830; Matter of Barbour's Estate, 185 App. Div. 445, 173 N.Y.S. 276, affirmed 226 N.Y. 639, 123 N.E. 854; 61 Corpus Juris 139, 140.

Socony-Vacuum Oil Co. v. City of New York, 247 A.D. 163, 287 N.Y.S. 288, 291 (1st Dep't 1936), aff'd, 272 N.Y. 668, 5 N.E.2d 385 (1936).

A review of the legislative history of FCLAA reveals no "clearly and distinctly expressed" legislative intent that the federal coal royalty be assessed on other federal, state, and local taxes. There is no evidence that Congress intended for the federal royalty to be a "tax on a tax."[13]

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[13] Congress stated that royalty rates should apply to the "value" of federal coal. States also place taxes on coal "value," however these taxes in no way increase that "value," but are simply a tax on that value.

MMS's Proposed Regulations correct the "tax on a tax" problem -- in part. Under the proposals, the federal black lung tax, 26 U.S.C. § 4121 (1980) and the abandoned mine reclamation fee, 30 U.S.C. § 1232 (1986), will not be subject to federal royalties. For many long-term contract purchasers, these taxes total 90 cents per ton -- 55 cents for black lung tax and 35 cents for the reclamation fee.[14] By excluding these taxes from the royalty base, royalties will be reduced by 13 cents per ton (.143 x $0.90).

WCTL supports MMS's proposal to deduct these taxes from the royalty base. Moreover, all state and local taxes -- not just federal taxes -- should be deducted from the royalty base.

MMS states that the two federal taxes should be deducted from the royalty base because the federal government could increase its royalties by increasing these (or other) taxes. Its Proposed Regulations state in pertinent part:

> In the proposed regulation, MMS has proposed language in brackets to exclude two types of reimbursements which otherwise would be included in the definition of gross proceeds, i.e., reimbursements for Federal black lung fees and reimbursements for abandoned mine

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[14] The black lung tax currently equals the lesser of 55 cents per ton or 4.4 percent of the sales price. 26 U.S.C. § 4121. The abandoned mine reclamation fee equals the lesser of 35 cents per ton or 10 percent of the value of the coal. 30 U.S.C. § 1232.

> lands fees authorized by the Surface Mining Control and Reclamation Act of 1977, 30 U.S.C. 1201 et seq. MMS received several requests to exclude these fees because the Federal Government effectively could increase royalties by increasing the fees. The MMS recognizes that similar arguments could be made about other items which are proposed to be included in the definition of gross proceeds and the exclusion of Federal black lung fees and abandoned mine lands fees could set a precedent for the exclusion of other items. The MMS also recognizes that the exclusion of these two Federal fees would lead to a reduction in royalty collections. MMS specifically requests comments on these issues.

Proposed Regulations, 52 Fed. Reg. at 1842.

Obviously, states -- like the federal government -- can raise royalty returns by raising their taxes as well. As discussed, supra, fifty percent of federal coal royalties are returned directly to producing states. By increasing their state and local taxes, states can increase their federal royalty returns. For this very reason, the President's Commission on Fair Market Value Policy for Federal Coal Leasing -- a blue ribbon panel appointed by the President to study coal leasing issues -- concluded that state and local taxes should be excluded from the FCLAA royalty tax base:

> Conclusion: The Commission concluded that the Federal royalty should be based on the value of the coal being produced, not on State and local taxes as well. Federal royalty policies should not create an incentive for higher State and local severance taxes -- or similar production based taxes -- by in-

> creasing the effective total return to a given percentage tax. State and local governments should bear the direct responsibility for the full financial impact of their severance taxes.
>
> Accordingly, the Commission recommends that:
>
> (REC. VII-5) THE BASE FOR CALCULATING FEDERAL ROYALTY PAYMENTS SHOULD BE THE F.O.B. PRICE MINUS ALL STATE AND LOCAL SEVERANCE AND SIMILAR TAXES.

Report of the President's Commission on Fair Market Value Policy for Federal Coal Leasing ("Linowes Commission Report") at 321 (1984).

Producer states are already reaping massive sums through their post-OPEC coal severance taxes and related fees, charges, and taxes. It is not in the broader public interest to further aggrandize producer state revenues at the expense of the nation's electric utility ratepayers.

B. ROYALTIES CANNOT BE COLLECTED ON "TAKE-OR-PAY" PAYMENTS

MMS's Proposed Regulations provide that royalties will be assessed against gross proceeds including "take-or-pay payments," and certain other producer receipts unrelated to the mining of coal. The Proposed Regulations state:

> Gross proceeds, as applied to coal includes: Payments or credits for advanced prepaid reserve payments subject to recoup-

> ment though reduced prices in later sales; advanced exploration or development costs that are subject to recoupment through reduced prices in later sales; take-or-pay payments . . . .

Id. at 1849. "Take-or-pay payments" are defined by MMS as follows:

> Take-or-payment means any payment received by the lessee under a 'take-or-pay' clause in its sales contracts. Such clauses normally require the purchaser to take, or, failing to take, to pay for a minimum contracted volume or other measure of coal. Under such a clause, the purchaser may have the right to take coal paid for (but undelivered) in succeeding years.

Id. at 1850.

The assessment of royalties on "take-or-pay" payments appears to be a new MMS policy proposal. Under existing regulations, royalties are assessed only against coal produced and sold. 30 C.F.R. § 203.200(f) (1985).

MMS lacks the statutory authority to assess royalties on take-or-pay payments. By statute, MMS can assess rentals, production royalties and advance royalties on coal lessees. 30 U.S.C. § 207 (1986). These three charges are typically set out in federal coal leases in the following format:

> Sec. 5. RENTAL - An annual rental of $3.00 for each acre or fraction thereof shall be paid in advance on or before each anniversary date of this lease. This section shall not be subject to revision except in the course of lease readjustment.
>
> Sec. 6. PRODUCTION ROYALTY - The lessee shall pay a production royalty of 12½ percent of the value of coal produced by strip or auger methods. . . .
>
> Sec. 7. ADVANCE ROYALTY - Upon request by the lessee the District Mining Supervisor may accept, for a total of not more than 10 years, the payment of advance royalties in lieu of continued operation consistent with the regulations in 43 CFR 3473 and 30 CFR 211 . . . .

Coal Lease NM 52786 (effective June 1, 1983).

The 12.5% royalty MMS wants to apply against take-or-pay payments is the rate that applies to "production."[15] Thus, MMS wants to apply a production royalty to a payment that expressly applies to tonnages not produced. Congress did not intend for production royalties to apply to non-production related payments.

30 U.S.C. § 207 provides that production royalties shall equal "not less than 12½ per centum of the value of coal as

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[15] As MMS has stated elsewhere, "[t]he Mineral Leasing Act of 1920, as amended, requires a statutory minimum production royalty rate of 12½ percent for surface mined coal (30 U.S.C. § 207) . . . ." Royalty Reduction Guidelines, supra, 50 Fed. Reg., 6062, 6063 (1985) (emphasis added).

defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations." Id. The plain language of Section 207 ties royalty assessment to "coal value" and "coal recover[y]." Id. In the absence of production, there is no "coal recover[y]."

Moreover, MMS's proposals could lead to the double recovery of royalties for the same coal -- a result clearly not intended by Congress. This can be seen by way of a simple example. Assume that a mine has 1,000,000 tons of commercially mineable federal coal, and two coal purchasers, each of which must buy a minumum of 500,000 tons, or pay a take-or-pay penalty equal to the coal sales price -- $10.00 per ton. If each purchaser bought 500,000 tons, MMS would collect $1,250,000 ($10.00 x 1,000,000 tons x .125). However, assume that one purchaser misses the minimum, buying only 400,000 tons, and the second purchaser buys 600,000 tons. Now MMS will not only collect the $1,200,000, it will also collect the first purchaser's take-or-pay payment -- $125,000 ($10.00 x 100,000 tons x .125). Thus, the 100,000 ton "take-or-pay" coal is subject to two royalty payments.

Take-or-pay payments in coal supply contracts are generally a form of liquidated damages exacted when minimum annual purchase obligations are not met. The coal not taken by the purchaser remains in the ground and, when extracted, is subject to a production royalty. Applying a production royalty to a take-or-pay charge is a prohibited form of double recovery.

Some coal supply contracts could provide that "take-or-pay" charges made will at some future date be used to reduce the price of future coal purchases. This appears to be the practice in the gas industry. See Diamond Shamrock Exploration Co. v. Hodel, C.A. No. 86-537, slip op. (E.D. La. Jan. 23, 1987). If MMS believes it possesses the statutory authority to assess production royalties on take-or-pay payments, royalties should be assessed only in those instances where take-or-pay payments are used to reduce future coal purchase prices to below-market levels.

C. MMS SHOULD DELETE ITS PRUDENT OPERATOR STANDARD

Proposed Regulations § 206.259(e) provides a "prudent operator" test to determine whether federal coal lessees are obtaining maximum revenues under their supply contracts:

> (e) Value shall be based on the highest price a prudent operator could receive under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty at a value based upon that obtainable price or benefit. Contract revisions or amendments shall be in writing, and signed by all parties to an arm's-length contract, and may be retroactive. If the lessee makes timely application for a price increase al-

> lowed under its contract but the purchaser refuses, and the lessee takes reasonable measures, which are documented, to force purchaser compliance, the lessee will owe no additional royalties until monies or consideration resulting from the price increase are received. This subsection applies to price increments only and shall not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part, for a quantity of coal removed or sold from a lease.

_Id._ at 1852.

This rule is needed, in MMS's view, to insure coal lessees act prudently:

> Proposed § 206.259(e) would expressly impose a diligence requirement on lessees. For example, if pursuant to an arm's-length contract a lessee could charge its purchaser a higher price as of a certain date, if the lessee fails to take proper and timely action to collect that additional money, the lessee would be liable for royalty on the higher value. However, if the purchaser refuses to pay and the lessee attempts to enforce its right, using reasonable, documented measures, it would not be required to pay the additional royalties until the lessee's efforts are successfully concluded. MMS believes that this regulation reflects the lessee's obligation to operate the lease prudently for the mutual benefit of itself and the lessor.

_Id._ at 1844.

The proposed rule is a classic example of regulatory overkill. WCTL members are unaware of any situation where a coal producer has failed to act to maximize what it perceives to be its best economic interests. Moreover, the regulation as written raises several questions: will MMS permit a royalty reduction when a contract amendment contains a lower price; when is it, or is it not, prudent to adjust contract prices; will MMS endeavor to interpret escalation clauses, BTU adjustment provisions, etc. in individual contracts, and question their application, etc.

As drafted, proposed § 206.259(e) is very ambiguous and could give MMS unprecedented power to second-guess the "prudency" of coal contract actions. MMS's carte blanche to question coal contracting prudency could very well have a chilling impact on coal contract negotiations. Neither purchasers nor producers would know whether or when MMS might find contract actions to be "imprudent." The royalty impact of price reductions would be particularly open to doubt and dispute.

Even if MMS continues to base royalties on "sales prices" or "gross proceeds," Section 206.259(e) should be eliminated. Coal operators' self-interests will insure a maximum return to the federal treasury. MMS can insure that contract payments are correct through standard audit procedures.

D. WASHING/TRANSPORTATION ALLOWANCES

If a "gross proceeds" standard is adopted, WCTL supports MMS's proposals to allow washing and transportation allowances. WCTL disagrees, however, with MMS's proposals to "cap" the amount of these allowances. The full amount of these allowances should be authorized.

V.

THE PROPOSED COAL INDUSTRY/UTILITY INDUSTRY VALUATION REGULATIONS SHOULD BE ADOPTED BECAUSE THEY REPRESENT A FAIR BALANCE OF COMPETING REVENUE INTERESTS

WCTL supports the Coal Industry/Utility Industry valuation proposal presented by the subscribing coal and utility trade associations. That proposal contains a section-by-section analysis of proposed regulations, along with a detailed justification statement for each change.

WCTL believes that the Coal Industry/Utility Industry valuation proposal reaches a fair balancing of producing state/consumer interests. Under the proposal, the valuation point will be at the point used to determine gross income for depletion purposes under the Internal Revenue Code. Unlike the MMS proposal, state and local taxes and the federal coal royalty will not be included in the royalty base. The proposal also precludes royalty assessments on "take-or-pay" payments, and makes several other changes advocated in this statement.

The Coal Industry/Utility Industry valuation proposal is a fair compromise. WCTL initially proposed that all coal be valued at current market prices (not at the inflated post-OPEC long term contract prices now in effect). In terms of revenue impact, the Coal Industry/Utility Industry valuation proposal generates far more per ton term contract royalty revenues to the states than would a current market value valuation model.

Moreover, producing states' concerns about "revenue maximization" must be reviewed in the context of FCLAA lease readjustments. Producing states generally claim that (for example) if all taxes are deducted from a royalty base, they will obtain less monies. However, look at what is going on. For years utility customers paid about $0.20 per ton for federal coal royalties. With the FCLAA readjustments, those rates increase to the $1.50-$4.00 range for term contracts under present MMS valuation proposals. If with tax adjustments, and other changes, this range drops somewhat, producing states are hard pressed to cry foul over fair valuation proposals when the FCLAA 12.5% rate level is driving up the previous $0.20 per ton royalties to previously unheard of (and WCTL submits, grossly unfair) levels.

even if the Coal Industry/Utility Industry proposal is accepted.[16]

In addition to being fair, the Coal Industry/Utility Industry Valuation proposal is short, simple to administer, and clear -- unlike the MMS's Proposed Regulations. To demonstrate this point, WCTL has endeavored to collate the Coal Industry/Utility Industry proposal into the typical Federal Register format with additions to the Proposed Regulations noted by underscored language and deletions to them noted by strike-throughs or Section delete notations.[17] Attachment 2 is a vast improvement over MMS's January 15, 1987 proposals.

VI.

ROYALTY POLICIES BASED SOLELY ON PRINCIPLES OF SHORT-TERM REVENUE MAXIMIZATION MAY ULTIMATELY LEAD TO DECREASED FEDERAL COAL PRODUCTION AND LONG-TERM REVENUE REDUCTIONS IN MANY COAL PRODUCING STATES

Purchasers of coal under long-term supply contracts are captive to DOI's royalty policies. Utilities have no choice but to accept and pay royalties produced by these policies. Thus, in the short-term, contract purchasers will be forced to bear huge price increases (unless MMS's current proposals are modified) because they have no competitive alternatives.

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[16] As described, infra, WCTL also submits that the last thing most, if not all, producing states need is a tax increase on federal coal located within their borders. As long-term coal supply contracts expire (or are otherwise terminated) within the next ten to fifteen years, utilities will endeavor to substitute the lowest price fuel for high-cost contract coal. This can mean not only shifts from one federal coal producing area to another, but also shifts away from federal coal altogether.

[17] Attachment 2 has not been reviewed by the subscribing parties to the Coal Industry/Utility Industry proposal, but WCTL believes it to be an accurate collation of their joint position.

Markets, however, have a way of penalizing suppliers who engage in short-term monopoly price gouging. Over the longer term, utilities and other coal purchasers may place increased reliance on boiler fuels other than coal, and will certainly look to comparable but lower cost non-federal coal whenever and wherever possible. Thus, in the long run, the federal government's royalty policies may chill federal coal production, and lower long-term revenues.

Other federal agencies share these concerns. The Department of Energy recently conducted an in-depth study of our nation's energy security. Its report concludes that the federal government "may lose revenues in the long run" under current royalty policies:

> Federal royalties on leases granted since 1976 generally have been 8 percent for underground mines and 12.5 percent for surface mines. When first imposed in 1976, these rates were far above prevailing levels; and if royalties on Federal coal are excessive, the Government may lose revenues in the long run -- while at the same time consumers pay higher-than-efficient prices for coal. In addition, pre-1976 lease royalties are typically paid on a cents-per-ton basis rather than being computed as a percentage.

> This situation may distort production away from the lowest cost coal supplies.

DOE Energy Security Report at 170 (1987).

The Energy Security Report calls on federal agencies to "remove unneeded barriers to effective efficiency along the [coal] supply chain" by, *inter alia*, "adjust[ing] . . . leasing regulations to reflect changes in coal markets." *Id.* at 178. This is precisely what WCTL's fair market value royalty proposals will accomplish.

High royalty assessments can, and do, discourage utilities that do have competitive alternatives from purchasing federal coal. Graphic evidence of this fact was provided at MMS's March 3 hearing in Denver by several utility spokesmen. Witness, for example, the statement presented by Tim K. Light, Manager of Solid Fuels for the Central Power & Light Company of Corpus Christi, Texas:

> As a public utility, we have the obligation to provide service to our customers at the lowest reasonable cost. This standard applies to fuel costs as well as the other aspects of our business. We currently have an obligation to take about three-fourths of our potential coal burn under a contract for coal mined on a federal lease, but the percentage of this coal decreases over time, and in the not too distant future, I might add. This leads me to what we are doing with the remainder of our fuel requirements, those

which are procured on the open market, or spot purchases if you will.

In light of the abundance of natural gas over the past couple of years, our location in south Texas and our proportionally significant amount of natural gas-fired generating capacity, gas can compete with coal as a CP&L boiler fuel. Currently, natural gas is available in the $1.40 to $1.60 per MMBtu price range, and believe me that is very competitive with coal that has to travel 1,000 to 1,500 or more miles to reach its destination.

In addition to this gas to coal competition, coal produced on federal lands also has to compete for our business with non-federal domestic coals as well as internationally marketed coal. We see increased levels of interest in our coal requirements from international producers and traders, and it is a factor that cannot be ignored. In January of this year, we brought a trial cargo of Australian coal in through the port of Corpus Christi, and later this year we plan to bring in a trial cargo of Columbian coal.

The bottom line is that CP&L cannot and will not simply purchase all the coal needed to completely load its coal-fired generating capacity from coal produced on federal lands as it did just a few years back. With declines in natural gas prices, increased federal coal royalty rates, and competitive non-federal and international coal supplies,- there is certainly a possibility that all of our coal purchases from federal leases could be replaced within the next ten years or so by alternative sources of fuel. Thus, high royalty rates -- intended to maximize federal and state revenues -- will backfire on the government as coal purchasers like CP&L use lower cost alternatives to federal coal.

Hearings on Revision of Coal Product Valuation Regulations and Related Topics Before the Department of the Interior, Minerals Management Service, Bureau of Land Management (March 3, 1987) (Statement of Tim K. Light at 1-3).

Ironically, in the long-run, DOI policies intended to generate "maximum revenues" could well produce exactly the opposite results in several western coal producing states. RDI, Inc. of Denver has recently completed a study on the impact of higher federal royalty rates on western coal states. This study shows that increases in royalty rates will hurt the competitiveness of high priced coal, and that most western states would be better off with royalties in the 5% range -- not 12.5%. A copy of the summary of the RDI Study is included as Attachment 3.

CONCLUSION

Adoption of the Coal Industry/Utility Industry valuation proposal will ease the financial burdens inherent in DOI's Proposed Regulations and demonstrate to utilities, and their customers, that the federal government will work with consumers to produce regulations that balance the interests of all concerned parties.

WCTL appreciates the opportunity to present this statement for the Subcommittee's review.

ATTACHMENT NO. 1

MEMBERS
WESTERN COAL TRAFFIC LEAGUE

Arizona Electric Power Cooperative, Inc.

Central Louisiana Electric Company, Inc.

Central Power & Light Company

City of Austin

City of Colorado Springs

City Public Service Board of San Antonio

Iowa Public Service Company

Kansas City Power & Light Company

Kansas Power & Light Company

Lower Colorado River Authority

Minnesota Power

Omaha Public Power District

Tuco, Inc.

Unitrain, Inc.

Utility Fuels, Inc.

ATTACHMENT NO. 2

PART 206—[AMENDED]

30 CFR Part 206 is amended as follows:

1. The authority citation for Part 206 is revised to read as follows:

   Authority: 25 U.S.C. 396 et seq.; 25 U.S.C. 396a et seq.; 25 U.S.C. 2101 et seq.; 30 U.S.C. 181 et seq.; 30 U.S.C. 351 et seq.; 30 U.S.C. 1001 et seq.; 30 U.S.C. 1701 et seq., 43 U.S.C. 1301 et seq.; 43 U.S.C. 1331 et seq., and 43 U.S.C. 1801 et seq.

2. Subparts E,F,G, and H of Part 206 are revised to read as follows:

Subpart E—Solid Minerals, General—[Reserved]

Subpart F—Coal

Subpart G—Other Solid Minerals—[Reserved]

Subpart H—Geothermal Resources

3. A new Subpart I is added to read "Subpart I—OCS Sulfur—[Reserved]."

4. Sections 206.300 and 206.301 under Subpart G are redesignated as new §§ 206.350 and 206.351 under new Subpart H, respectively.

5. 30 CFR Part 206 is amended by adding §§ 206.250, 206.251, 206.252, 206.253, 206.254, 206.255, 206.256, 206.257, 206.258, 206.259, 206.260, 206.261, 206.262, 206.263, and 206.264 to form newly redesignated Subpart F (formerly Subpart E) to read as follows:

Subpart F—Coal

Sec.
206.250 Purpose and scope.
206.251 Definitions.
206.252 Information collection.
206.253 General royalty management responsibilities of MMS.
206.254 General royalty obligations of the lessee.
206.255 Coal subject to royalties—general provisions.
206.256 Quality and quantity measurement standards for reporting and paying royalties.
206.257 Point of royalty determination.
206.258 Valuation standards for cents-per-ton leases.
206.259 Valuation standards for ad valorem leases.
206.260 ~~Washing~~ Processing allowances.
206.261 Allocation of ~~washed~~ processed coal.
~~206.262 Transportation allowances.~~
206.26~~3~~2 Contract submission.
206.26~~4~~3 In situ and surface gasification and liquefaction operations.
206.264 Disputed amounts

§ 206.250 Purpose and scope.

(a) This subpart prescribes the procedures to establish the value, for royalty purposes, of all coal production from Federal and Indian Tribal and allotted leases (except leases on the Osage Indian Reservation).

(b) If the specific provisions of any statute or treaty, or any coal lease subject to the requirements of this Part, are inconsistent with any regulation in this Part, then the lease, statute, or treaty provison shall govern to the extent of that inconsistency.

(c) All royalty payments made to the Minerals Management Service (MMS) are subject to later audit and adjustment.

§ 206.251 Definitions.*

(a) Ad valorem lease means a lease where the royalty due to the lessor is based upon a percentage of the amount or value of the production.

(b) Area means a geographic region in which coal has similar quality and economic characteristics. Area boundaries are not officially designated and the areas are not necessarily named.

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* Definitions of allowance, coal washing, selling arrangement and take-or-pay deleted, with definitions renumbered accordingly.

(c) Arm's-length contract means a contract or agreement between independent, nonaffiliated persons. For purposes of this subpart, two persons are affiliated if one person has actual control (s)over, is actually controlled by, or is under actual common control with another person as defined in Internal Revenue Service regulation 1.613-4(j) in effect January 1987. ~~(or if one person owns an interest (regardless of how small) either directly or indirectly in another person)~~

(d) Audit means a review, conducted in accordance with generally accepted accounting and auditing standards, of royalty payment compliance activities of lessees or other interest holders who pay royalties, rents, or bonuses on Federal or Indian leases. The term audit includes, but is not limited to, audit activities related to Federal leases located within the boundaries of any State which has entered into a cooperative agreement with MMS under the provisions of sections 202 or 205 of the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1732 or 1735), audit activities related to leases located on Indian lands, and the review and resolution of exceptions processed by any accounting systems maintained by the MMS. Audits may also be conducted in response to irregularities identified by BLM, MMS, BIA or a State or Indian Tribe in the performance of product verification.

(e) BIA means the Bureau of Indian Affairs of the Department of the Interior.

(f) BLM means the Bureau of Land Management of the Department of the Interior.

(g) Coal means of all ranks from lignite through anthracite.

(h) Contract means any oral or written agreement, including amendments or revisions thereto, between two or more persons and enforceable by law. ~~(that with due consideration creates obligation)~~.

(i) Gross royalty value of coal produced from a Federal lease is synonymous with "gross income from the property" as defined in Internal Revenue Code section 613(c) and regulations 1.613-3 and 1.613-4 in effect January 1, 1987, reduced by an amount equal to all royalties paid or incurred by the lessee with respect to the lease in accordance with Internal Revenue Code section 613(a).

(j) Indian allottee means any Indian for whom land or an interest in land is held in trust by the United States or who holds title subject to Federal restriction against alienation.

(k) Indian Tribe means any Indian tribe, band, nation, pueblo, community, rancheria, colony, or other group of Indians for which any land or interest in land is held by the United States in trust or which is subject to Federal restriction against alienation.

(l) Lease means a Federal lease, issued under the coal leasing provisions of the mineral leasing laws, which grants the exclusive right to extract coal.

(m) Lessee means any person to whom the United States, an Indian Tribe, or an Indian allottee issues a lease. ~~(and any person who has assumed an obligation to make royalty or other payments required by the lease. This includes all persons who have an interest in a lease as well as an operator or other payor who has no interest in the lease but who has assumed the royalty payment responsibility)~~

(n) Like-quality coal means coal which has similar chemical and physical characteristics.

(o) Marketable condition means coal which has undergone the processes of extraction, and, where necessary, primary crushing and screening.

(p) Mine means an underground or surface excavation or series of excavations and the surface or underground support facilities that contribute directly or indirectly to mining.

production, preparation, and handling of lease products.

(q) "Net-back method" means a procedure for valuing coal [~~at the lease or mine when a sale has taken place~~] down-stream from the lease or mine~~.~~ ~~The procedure~~ [~~involves~~] working back from the [~~sales~~] point of gross royalty value determination to arrive at [~~the~~] net royalty value [~~at measurement~~] at the first point of marketable condition. [~~For royalty purposes, consideration is given to the costs incurred in the transportation, handling, washing, etc., necessary to get the coal to the point of sale.~~]

(r) Net output means the quantity of [~~washed~~] coal [~~that a washing plant produces~~] delivered to the purchaser.

(s) Net royalty value (for royalty payment purposes) means gross royalty value attributable to a federal lease as defined in section 206.251, increased by amounts paid or incurred by the lessee for all royalties attributable to the federal lease, except federal royalties, and reduced by the processing allowance determined pursuant to section 206.260, federal black lung excise tax, abandoned mine lands fees and state and local taxes based on production attributable to coal produced from the lease.

(t) Person means any individual, [~~firm, corporation, association, partnership, consortium, or joint venture~~] or legal entity.

(u) Processing allowance means the amount deductible from gross royalty value for any processes or handling applied after coal produced from a federal lease has achieved marketable condition, to the extent that such processes and handling are included in the definition of gross royalty value. The amount of processing allowance shall be determined pursuant to section 206.260.

(v) Spot sales agreement means any sales transaction where [~~planned or~~] actual deliveries span a short period of time, usually not exceeding one year.

§206.252 Information collection.

The information collection requirements contained in Subpart F of Part 206 are being submitted for approval by the Office of Management and Budget (OMB) under 44 U.S.C. 3504(h). The information collection OMB clearance numbers are requested for the following:

Information collection	**OMB No.**
Requirement for submission of coal ~~quality~~ ~~and~~ quantity information under § 206.256.	1010-XXXX
Requirement for submission of coal sales contracts under § 206.262.	1010-XXXX
Requirement for submission of coal ~~washing~~ allowance reports under § 206.260.	1010-XXXX
~~Requirement for submission of coal transportation allowance reports under § 206.262.~~	1010-XXXX

The information is being collected by the Department of the Interior to meet its congressionally mandated responsibilities relating to Federal and Indian mineral royalty management. The information will be used to determine whether royalty payments represent the proper values for royalty purposes for minerals used or sold from Federal and Indian lands and to assure that proposed deductions from royalty payments are acceptable.

§ 206.253 General royalty management responsibilities of MMS.

It is the responsibility of MMS to:

(a) Obtain lessee reports of coal lease production, quantities, and qualities of coal lease products sold, reports of rentals and royalties due, and related matters;

(b) Collect and record rentals and royalties due from, and paid by, lessees;

(c) Process rental and royalty refunds;

(d) When necessary, [~~obtain~~] examine copies of lessee contracts (including contract updates and amendments), sales agreements, coal [~~washing~~] processing agreements, coal transportation agreements, publicly available prices, and other royalty valuation records when needed by MMS to assure that royalties are properly determined;

(e) Safeguard all proprietary information and records submitted to MMS by the lessee pursuant to lease terms and regulations, and to maintain the confidentiality of any financial information and/or trade secrets which may come into its possession or about which it may gain knowledge;

(f) Promptly deposit rentals and royalties in the U.S. Treasury and/or Tribal or allottee account; and

(g) Audit the records of lessee within 3 years from the date each royalty payment is due to determine that royalties have been paid properly to the Federal Government and Indian lessors.

§ 206.254 General royalty obligations of the lessee.

The lessee is required among other things to:

[~~(a) Properly handle and protect coal;~~

~~(b) Place coal in marketable condition at no cost to the lessor~~]

(ca) Accurately measure production. [~~properly maintain it in inventory, and dispose of it in a manner beneficial to the public or Indian tribe's or allottee's interest;~~]

(db) Maintain accurate records of production and sales[~~;~~] for a period of three years following the date each royalty payment is due.

(ec) Maintain copies of all contracts, sales agreements, [~~washing~~] processing or transportation agreements, and other records that support the prices, costs and values used in valuing coal for royalty purposes. Copies of these contracts, etc., are to be made available to MMS [~~either~~] in the lessee's office during normal office hours. [~~or provided to MMS in accordance with this Part at such time requested by the Department of the Interior;~~]

(fd) Make timely rental and royalty payments;

(ge) Make timely reports on production and sales quantities [~~and qualities; and~~]

[~~(h) Properly value production and correctly pay royalties;~~]

§ 206.255 Coal subject to royalties-general provisions.

(a) All coal [~~except coal unavoidably lost as determined by BLM pursuant to 43 C.F.R. Group 3400~~] produced pursuant to an approved resource recovery and protection plan and sold from a Federal or Indian lease subject to this Part is subject to royalty. This includes coal used by the lessee on lease or off lease.

(b) If a lessee receives compensation for unavoidably lost coal through insurance coverage or other arrangements, royalties at the rate specified in the lease are to be paid on the amount of compensation which is received for the coal lost.

(c) In the event waste piles or slurry ponds are reworked to recover coal, the lessee shall pay royalty at the rate specified in lease at the time of recovery. The royalty rate shall be that rate applicable to the production method used to initially mine coal in the waste pile or slurry pond, i.e., underground mining method or strip mining method. Coal in waste pits or slurry ponds initially mined from Federal or Indian leases shall be allocated to such leases regardless of whether it is stored on Federal or Indian lands. The lessee shall maintain accurate records to determine to which individual Federal or Indian lease coal in the waste pit or slurry pond should be allocated. [~~However, except as provided in §206.259(c),~~] ~~n~~Nothing in this section requires payment of a royalty on coal for which a royalty has already been paid.

§ 206.256 Quality and quantity measurement standards for reporting and paying royalties.

(a) (Deleted)

(a) For all leases subject to this subpart, the quantity of coal on which royalty is due shall be measured in short tons (of 2,000 pounds each) by methods prescribed by the BLM. Coal quantity information shall be reported on appropriate forms required under 30 CFR Part 216 and on the Report of Sales and Royalty Remittance, Form MMS-4014, as required under 30 CFR Part 210.

§ 206.257 Point of royalty determination.

(a) For all leases subject to this subpart, royalty shall be computed at the earlier of the point when [~~on the basis of the quantity and quality of~~] coal [~~in marketable condition at the point of royalty measurement prescribed by BLM~~] is produced and first placed in a marketable condition or loaded for delivery.

(b) Coal produced and added to the stockpiles or inventory does not require payment of royalty until such coal is later sold or otherwise ~~disposed of~~ consumed. ~~MMS may ask BLM or BIA to increase the lease bond to protect the lessor's interest when stockpiles or inventory become excessive as determined by BLM.~~]

(c) The lessee shall pay royalty at a rate specified in the lease at the time the coal is sold or [~~otherwise disposed of~~] consumed unless otherwise provided for at 30 CFR 206.258 (d).

§ 206.258 Valuation standards for cents-per-ton leases.

(a) This section is applicable to coal leases on Federal, Indian Tribal, and allotted Indian lands (except leases on the Osage Indian Reservation) which provide for the determination of royalty on a cents-per-ton (or other quantity) basis.

(b) The royalty for coal produced from leases subject to this section shall be based on the dollar rate per ton prescribed in the lease. That dollar rate shall be applicable to the actual volume of coal sold or used. [~~including coal which is avoidably lost as determined by BLM pursuant to 43 CFR Group 3400~~].

[~~(c) For leases subject to this section, there shall be no allowances for transportation, removal of impurities, coal washing or any other processing or preparation of the coal.~~]

~~(d) When a coal lease is readjusted pursuant to 43 CFR Subpart 3451 and the royalty valuation method changes from a cents-per-ton basis to an ad valorem basis, coal which is produced prior to the effective date of readjustment and sold or used within 30 days of the effective date of readjustment shall be valued pursuant to the provisions of § 206.259, and royalties shall be paid at the royalty rate specified in the readjusted lease.~~

§ 206.259 Valuation standards for ad valorem leases.*

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* Paragraphs b-f were deleted, with new paragraphs renumbered.

(a) This section is applicable to coal leases on Federal, Indian Tribal, and allotted Indian lands (except leases on the Osage Indian Reservation), which provide for the determination of royalty as a percentage of the value of production (ad valorem). The value for royalty purposes of coal produc[~~tion~~]ed and sold from such leases or consumed shall be the net royalty value of coal [~~determined pursuant to~~] as defined in section 206.251. [~~paragraph (b) or (c) of this section, less applicable coal washing allowances and transportation allowances determined pursuant to sections 206.260 and 206.262.~~]

(b) If there is a sale of coal under a non-arm's length contract, or other disposition other than by arm's length contract, the criteria for determining gross royalty value shall be as prescribed in Treasury regulation 1.613-4(b)(2), based on a representative market or field price method.

(c) [~~The lessee is required to place coal in marketable condition at no cost to the Federal Government or Indian lessor.~~] Where the net royalty value established pursuant to this section is determined by a lessee's [~~gross proceeds~~] gross royalty value, that value shall be increased to the extent that it is understated [~~the gross proceeds has been reduced~~] because the purchaser, or any other person, is providing certain services, the cost of which ordinarily is the responsibility of the lessee, to place the coal in marketable condition. Any contractual arrangements or amendments or revisions thereto regarding services between the lessee and purchaser that are in effect at the time of promulgation of these rules shall not affect value determination.

(d) If the lessee requests a value determination from MMS, the lessee may pay royalties based upon a value consistent with the requirements of this section until MMS issues a value determination. After MMS issues a value determination requested by a lessee, or after MMS issues a value determination based upon a review or audit of royalty values, the payor is required to pay any additional royalties due plus interest computed pursuant to 30 CFR 218.200, retroactive to the effective date of the value determination. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit. MMS shall not pay interest on any credit.

(e) [~~Certain~~] Any information [~~submitted~~] provided [~~to MMS to support valuation proposals, including transportation and/or processing allowances, is~~] pursuant to this subpart shall be exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 522. Any data specified by the Act to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable law and regulations. All requests for information about determinations made under this Part are to be submitted in accordance with the Freedom of Information Act regulation of the Department of the Interior, Title 43 CFR Part 2.

§ 206.260 ~~Washing~~ Processing allowances.

If the gross royalty value of coal produced from a federal lease as defined in section 206.251 includes amounts generated by processes or handling applied after the coal has achieved marketable condition as defined in section 206.251, such amounts shall be deducted as a processing allowance in arriving at net royalty value. The processing allowance shall be calculated using the "netback method" as defined at section 206.251 by multiplying gross royalty value by a fraction, the numerator of which is the cost of all post marketable condition processes and handling and the denominator of which is the total costs of all pre and post marketable condition processes and handling. The computation may be illustrated by the following equation:

$$\text{Gross Royalty Value} \times \frac{\text{Post Marketable Condition Costs}}{\text{Total Costs}} = \text{Processing Allowance}$$

Sec. 206.261 - Allocation of [~~washed~~] processed coal

(a) When coal is subjected to a [~~washing~~], processing allowance the [~~washed~~] processed coal [~~allocated~~] must be allocated to the leases from which it was produced.

(b) When the net output of coal from a [~~washing plant~~] processing facility is derived from coal obtained from only one lease, the quantity of [~~washed~~] processed coal allocable to the lease will be based on the net output of the [~~washing plant~~] processing facility.

(c) When the net output of coal from a [~~washing plant~~] processing facility is derived from coal obtained from more than one lease, the quantity of net output of [~~washed~~] processed coal allocable to each lease will be based on the ratio of measured quantities of coal delivered to the [~~washing plant~~] processing facility and washed from each lease compared to the total measured quantities of coal delivered to the [~~washing plant and washed~~] processing facility and processed.

§ 206.262 Contract submission.*

(a) The lessee and other payors shall make available [~~submit~~] to MMS, [~~upon request~~] for review contracts for the sale of coal from ad valorem leases subject to this subpart. Nothing in this subsection shall be construed to limit the authority of MMS to obtain or have access to information pursuant to 30 CFR Part 212.

(b) Lessees and other payors shall designate, for each contract [~~submitted pursuant to this section~~] whether the contract is arm's-length or non-arm's-length.

(c) A lessee's determination that its contract is arm's-length is subject to future audit to verify that the contract meets the criteria of the arm's-length contract definition in § 206.251.

(d) Information [~~required to be submitted~~] made available under this section which constitutes trade secrets and commercial and financial information which is identified as privileged or confidential shall not be available for public inspection or made public or disclosed without the consent of the lessee or other payor, except as otherwise provided by law or regulation.

Sec. 206.263 In-situ and surface gasification and liquefaction operations.

If an ad valorem federal coal lease is developed by in-situ technology, the value of production for purposes of computing royalty shall be determined by MMS. If coal from an ad valorem federal coal lease is produced using conventional mining methods and subsequently liquefied, gasified or thermally dried to remove inherent moisture, the royalty shall be based on the net royalty value of the feedstock coal determined pursuant to Section 206.259 at the point the feedstock first achieved marketability.

Sec. 206.264 Disputed amounts.

Whenever a dispute as to the amount owed on a royalty arises by the government's demand for payment plus interest, the lessor and the lessee may enter into a contract whereby such disputed sums placed into an escrow account to be held by the United States Government with the interest accruing under said account to be available upon final resolution, either by administrative or judicial determination to be paid to the prevailing party. In the absence of such a contract for interest bearing escrow account, should the lessee prevail in the administrative or judicial resolution of a disputed amount of royalty due, the government shall allow a credit for the amount of over-payment, plus interest accrued, to be applied to the lessee's future royalty obligation.

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* 206.262 Transportation allowance is deleted in its entirety.

PART 212-[AMENDED]

30 CFR Part 212 is amended as follows:

1. The Authority citation for Part 212 is revised to read as follows:

Authority: 25 U.S.C. 396 et seq., 25 U.S.C. 396a et seq.; 25 U.S.C. 2101 et seq., 30 U.S.C. 181 et seq., 30 U.S.C. 351 et seq.; 30 U.S.C. 1001 et seq.; 30 U.S.C. 1701 et seq.; 43 U.S.C. 1301 et seq., 43 U.S.C. 1331 et seq.; and 43 U.S.C. 1801 et seq.

2. Subparts F and G under Part 212 are revised to read as follows:

Subpart F--Coal [Reserved]

Subpart G--Other Solid Minerals--[Reserved]

3. The following subparts are added to Part 212:

Subpart H--Geothermal Resources--[Reserved]

Subpart I--OCS Sulfur--[Reserved]

PART 218--[AMENDED]

30 CFR Part 218 is amended as follows:

1. The Authority citation for Part 218 is revised to read as follows:

Authority: 25 U.S.C. 396 et seq., 25 U.S.C. 396a et seq., 25 U.S.C. 2101 et seq., 30 U.S.C. 181 et seq.; 30 U.S.C. 351 et seq., 30 U.S.C. 1001 et seq., 30 U.S.C. 1701 et seq., 43 U.S.C. 1301 et seq., 43 U.S.C. 1331 et seq., and 43 U.S.C. 1801 et seq.

2. 30 CFR Part 218 is amended by revising newly redesignated § 218.201 (formerly § 203.200(b)) to read as follows:

Sec. 218.201 Royalty payments.

Operators/lessees shall submit royalty payments as provided for in the lease and the regulations in this Title. The payment shall be made by the end of the month after the end of the royalty reporting period for which the royalty accrued. However, if a different reporting period is provided for in the lease, the lease terms shall prevail.

TITLE 43 --[AMENDED]

For the reasons stated in the preamble, 43 CFR Group 3480 is amended as follows:

1. The authority citation for 43 CFR Part 3480 continues to read as follows:

Authority: The Mineral Leasing Act of February 25, 1920, as amended (30 U.S.C. 181 et seq.); the Mineral Leasing Act for Acquired Lands of 1947, as amended (30 U.S.C. 351-359); the Surface Mining Control and Reclamation Act of 1977 (30 U.S.C. 1201, et seq.), the National Historic Preservation Act of 1966, as amended (16 U.S.C. 470, et seq.); the Endangered Species Act of 1973, as amended (16 U.S.C. 1531, et seq.); the Act of March 3, 1909, as amended (25 U.S.C. 396); the Act of May 11, 1938, as amended (25 U.S.C. 396a-396g); the Act of February 28, 1891, as amended (25 U.S.C. 397); the Act of May 29, 1924 (25 U.S.C. 398); the Act of March 3, 1927 (25 U.S.C. 398a-398e); the Act of June 30, 1919, as amended (25 U.S.C. 399); R.S. 441 (43 U.S.C. 1457); the Federal Property and Administrative Services Act of 1949, as amended (40 U.S.C. 471, et seq.); The National Environmental Policy Act of 1969, as amended (42 U.S.C. 4321, et seq.); and the Freedom of Information Act (5 U.S.C. 552).

2. 43 CFR 3485.2 is amended by removing paragraphs 3485.2(d), 3485.2(e), 3485.2(f), 3485.2(g), 3485.2(h), 3485.2(i), and 3485.2(k), and 3485.2(j) is redesignated to 3485.2(d).

(FR Doc. 87-896 Filed 1-14-87; 8:45 am)

BILLING CODE 4310-MR-M

ATTACHMENT NO. 3

THE ECONOMIC AND MARKET IMPACTS OF RISING FEDERAL COAL ROYALTY RATES

Prepared for
The Western Coal Traffic League

Prepared by
Resource Data International, Inc.
Boulder, Colorado

November, 1987

THE ECONOMIC AND MARKET IMPACTS
OF RISING
FEDERAL COAL ROYALTY RATES

EXECUTIVE SUMMARY

Background

Between now and 1991, western coal consumers and producers, western states and the federal government will feel the full impact of federal coal royalty legislation that was enacted over ten years ago. Well over two-thirds of all western coal production is on federal land, and much of the remainder is tied to mining operations producing on predominantly federal leases. Since the Federal Coal Leasing Amendments Act (FCLAA) was passed in 1976, things have changed for western coal — the market has matured, the real price of coal has plummeted, the number of mines has fallen by 20%, direct mining employment has dropped by more than 4,000 jobs and resulting revenues to state and local governments have fallen similarly.

Many western coal producers have reached the twenty-year anniversary dates on federal leases, and this has triggered notices of royalty hikes from a flat cents-per-ton basis to a percentage of the "value" of the coal. However, most of these producers continue to pay the old rates pending formal protest, litigation and appeals. A few other western coal producers have had their royalty hikes waived or suspended, and the balance will become subject to the higher rates by 1991. Because of this mix, the current effective federal royalty rate being paid across the West is 4.7%. This compares to a region-wide average rate of 12.2% if current DOI guidelines are ultimately fully implemented. Exhibit I provides a summary of western coal leases by basin.

Exhibit I

Western Coal Lease Summary by Basin
Based on Fiscal Year 1986 (October 1985 - September 1986)

	Number of Active Coal Leases	1986 Effective Royalty Rate (%)	Total Production (MM Tons)	Production From Federal Leases (MM Tons)	% Federal
Green River - Colorado (s)	9	8.5	9.7	6.2	64
Green River - Colorado (u)	5	8.0	1.6	0.3	19
Green River - Wyoming (s)	15	5.1	19.1	7.2	38
Fort Union - Montana	1	12.5	0.2	0.2	100
Fort Union - North Dakota	9	9.1	25.8	6.2	24
Centralia - Washington	1	12.5	4.6	0.6	12
San Juan - Colorado	1	8.0	0.07	0.1	100
San Juan - New Mexico	6	12.5	19.6	6.5	33
Powder River - Montana	9	5.7	31.4	21.4	68
Powder River - Wyoming	59	2.5	112.4	99.6	89
Uinta - Colorado	17	3.6	4.2	3.4	81
Uinta - Utah	27	4.6	13.9	9.6	69
Other Western Basins	0		1.03	0	0
	159	4.7	243.6	159.3	65

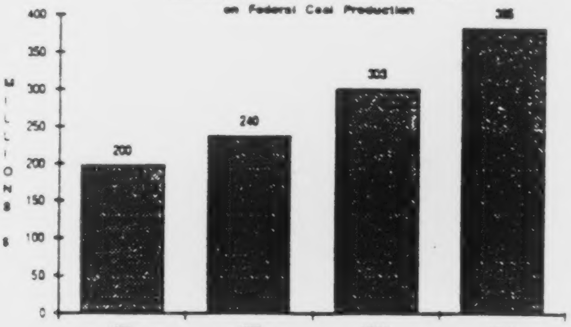
Utility & Consumer Impacts

Should all western producers begin to pay, forthwith, full royalties calculated according to the current Department of the Interior (DOI) regulations, royalties on federal coal will jump from the 10 cents-20 cents per ton range to anywhere from $.38 to $4.00 per ton. This would have an immediate detrimental effect on utilities that burn western coal. Exhibit II shows that there would be a fuel cost increase to these utilities of at least $200 million per year by 1990, that could grow to $385 million per year by 2005.

Exhibit II

ANNUAL COST INCREASES TO UTILITIES & CONSUMERS

Resulting from Royalty Induced Price Hikes on Federal Coal Production



Cost of Full DOI Royalty Rates Impact Compared to Cost Based on FCLAA Royalty Rate on $0.20 Per Ton

Source - Appendix A

Coal Market Impacts

However, Central and Western fuel and power markets will react to a royalty-induced price surge for western coals. So in reality the utility cost impacts will never reach the $385 million per year level illustrated in Exhibit II above as utilities endeavor to switch purchases from high price federal coal to lower priced coals or alternative fuels.

Exhibit III shows the 1986 market size and reach for western coal as well as the west's share of the total coal market in the four major national coal markets it serves. The findings of this study highlight three major market impacts expected to result from higher priced western coals:

- Impacts of Diversion to Powder River Basin Coal

  Royalty increases will widen the existing price differentials between Wyoming Powder River Basin (PRB) coals and other coals that compete with Wyoming PRB, further contributing to the loss of existing and future coal production in high cost producing areas.

- Impacts of Diversion to Eastern and Foreign Coal

  In the Central markets, royalty increases will add to the price of western coal, making this coal less competitive with low-sulfur non-federal coal primarily from Central Appalachia but also imported coal from Columbia and Australia.

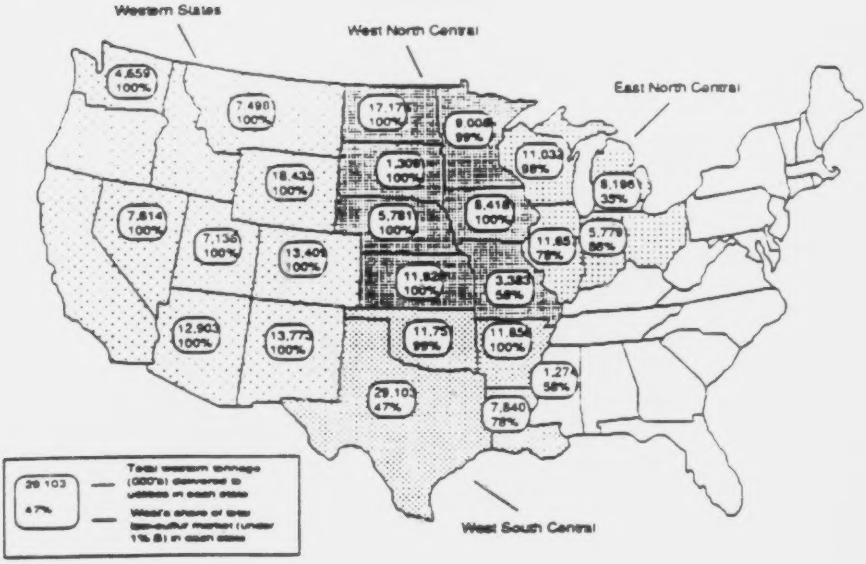
- Impacts of Utility Dispatch

  In both the Central and Western regions, western coal will lose some of its potential maximum share of the electric generation market to alternative fuels (e.g., gas, oil, nuclear and hydro).

Exhibit III

Market Size, Share and Reach for Western Coal

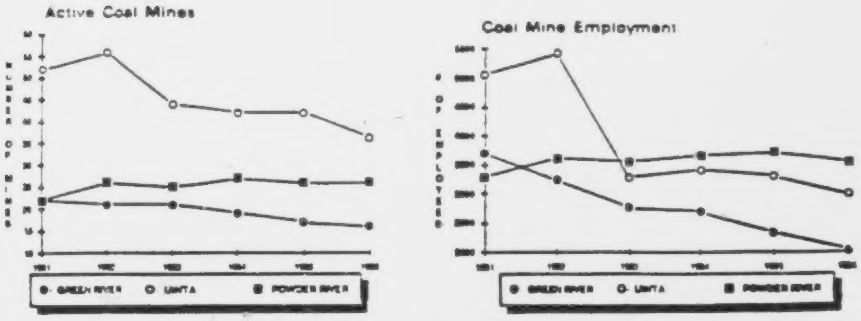
(1986 Utility Markets Only)


Western States
West North Central
East North Central
West South Central
4,659 100%
7,498 100%
17,17 100%
9,00 99%
1,30 100%
18,43 100%
11,03 98%
8,196 35%
7,814 100%
7,136 100%
5,781 100%
8,41 100%
11,85 78%
5,779 86%
13,40 100%
11,82 100%
3,383 58%
12,903 100%
13,77 100%
11,75 99%
11,85 100%
1,27 58%
29,10 47%
7,840 78%
29 103
47%
Total western tonnage (000's) delivered to utilities in each state
West's share of total low-sulfur market (under 1% S) in each state

"At Risk" Production

Regardless of how these market forces ultimately play out the net effect will be to place substantial tonnages of western coal "at risk." With the exception of the Powder River Basin of Wyoming, over the past five years the number of western coal mines and miners have dropped radically (Exhibit IV).

Exhibit IV



The coal industry in Colorado, Utah, Southern Wyoming, Montana and New Mexico remains extremely fragile, and even under the most favorable market conditions will be hard pressed to maintain market share. A recent Department of Interior (DOI) study estimates that newly competitive rail rates out of the PRB alone could place at risk as much as 22 million tons per year (mmtpy) of other western coals. While this number may seem high, our analysis indicates that royalty-induced production losses of one to four million tons per year are highly likely in those western states and regions that are already marginal producers.

State & Local Impacts

In 1986 western states derived approximately $528 million in direct revenue from coal mining. Of this amount, only $48 million (or 9.1%) came from the states' share of federal royalties. The lion's share of state revenues are derived from taxes and state royalties that are very sensitive to gross production levels. Thus, higher federal royalties will increase state revenues only if the royalty-induced price surge does not harm production. Exhibit V demonstrates that for 5 of the 6 major federal coal producing states, production losses of federal coal in the 1 to 4 million ton range will generate state revenue losses that will offset all state revenue gains produced by increasing federal royalties in 1990 and 1995 to the full FCLAA level.

Exhibit V

SUMMARY OF IMPACT ON STATE REVENUES FROM INCREASE IN FEDERAL ROYALTY RATE — 1990 & 1995

(amounts in thousands)

STATE (1)	TONNAGE TOTAL (2)	TONNAGE FEDERAL (3)	REVENUES WITH ROYALTIES AT: 4.64% OF SALES PRICE (4)	REVENUES WITH ROYALTIES AT: 12.5/8.0% OF SALES PRICE (5)	GAIN IN REVENUES COL(5)-COL(4) (6)	TONNAGE TO OFFSET COL(6) REVENUE GAIN (7)
1990						
1. Colorado	15,200	9,272	$22,179	$28,907	$ 6,728	2,158
2. Montana	36,600	24,888	90,209	103,884	13,675	3,276
3. North Dakota	28,700	6,888	12,879	16,583	3,704	1,539
4. New Mexico	17,600	4,400	10,525	14,990	4,465	1,311
5. Utah	17,000	11,730	24,343	27,968	3,625	1,521
6. Wyoming						
a. Powder River Basin	133,000	118,370	204,174	251,769	47,595	22,377
b. Green River	15,200	5,776	18,920	19,859	939	273
7. Total	263,300	181,324	$383,229	$463,960	$80,731	32,455
1995						
1. Colorado	15,400	9,394	$22,320	$30,130	$ 7,810	2,155
2. Montana	37,100	25,228	85,860	103,699	17,839	4,340
3. North Dakota	31,700	7,608	14,284	18,446	4,162	1,717
4. New Mexico	14,600	3,650	8,798	12,586	3,788	1,099
5. Utah	19,000	13,110	26,812	31,787	4,975	2,092
6. Wyoming						
a. Powder River Basin	157,000	139,730	247,373	307,718	60,345	27,402
b. Green River	15,400	5,852	18,947	23,894	4,947	1,212
7. Total	290,200	204,572	$424,394	$528,260	$103,866	39,977

Source: Appendix F and Appendix G.

For example, Colorado production in 1990 is projected at 9.2 million tons provided the federal coal royalty equals 4.64% of the sales price. At this level, Colorado would collect $22.2 million in taxes and state-share federal royalties on the 9.2 million federal tons. If the royalty rate is increased to the full applicable FCLAA level, Colorado's share of federal royalties will increase by $6.7 million (to $28.9 million) assuming that the 9.2 million federal tonnage level remains constant. However , the increase in the royalty will add to the price of the Colorado coal and increase buyers' incentives to find lower cost alternatives. If, as a result, Colorado federal production drops below 7.1 million tons circa 1990 - - which is highly likely - - the state will collect less revenues than $22.2 million (i.e., less revenues than it would have collected had a 4.64% royalty been utilized). The projected 1990 "break point" production loss in Colorado – that is the point at which the state experiences a net revenue loss in spite of higher federal royalties – is 2.2 mmtpy.

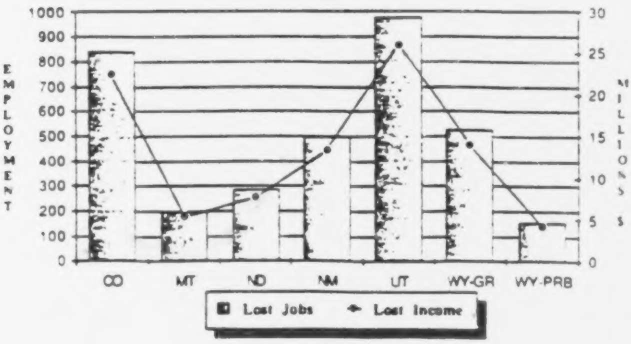
A 1995 analysis comparable to the 1990 impact on state revenues summarized in Exhibit V is contained in Appendix G.

Employment and Income

The most significant secondary impacts of lost coal production in western states are the losses in jobs and personal income. Exhibit VI is an "apples-to-apples" comparison of the relative impacts of a 4 mmtpy loss in each producing state. In Utah, where underground mining correlates to more jobs per ton, a 4 mmtpy production loss would result in nearly 1000 lost jobs and a concomitant $27 million in lost personal income. To put this in perspective, it should be noted that Utah lost more than 4 mmtpy of production between 1982 and 1985 due to competitive market forces.

Exhibit VI

LOST EMPLOYMENT AND PERSONAL INCOME DUE TO A 4 MILLION TON DROP IN PRODUCTION IN 1990



Summary

Western coal markets are currently in a state of flux, and with the exception of Wyoming's Powder River Basin, there is a substantial amount of production "at risk." As the cost of these coals is forced up by a federal royalty-induced price surge, the market will be further disrupted resulting in localized tonnage losses of at least 1 to 4 mmtpy and a total intra- and inter-regional production shift of between 20-27 mmtpy.

State revenues are extremely sensitive to incremental losses in tonnage. Even the most conservative estimates of market disruption in key states indicate a negative net effect on revenues, employment and income.

STATEMENT BY

Fredrick D. Palmer
General Manager
Western Fuels Association, Inc.

To the
Committee on Mineral Resources Development and Production
Committee on Energy and Natural Resources

Hearing on Valuation of Coal Production from Federal
and Indian Leases for Federal Royalty Purposes

November 16, 1987

Mr. Chairman, I appreciate the opportunity of getting the views of my organization, Western Fuels Association, Inc., before this Subcommittee, and I commend you and the Subcommittee for putting the spotlight on proposals of the Minerals Management Service of the Department of the Interior as they relate to establishing product valuation procedures for use in determining federal coal royalty rates.

I am Fredrick D. Palmer, general manager of Western Fuels, a not-for-profit organization which generally buys millions of tons of coal produced from federal leases and operates one of its own mines on federal leases in northwestern Colorado. Western Fuels has been active in seeking leases and in contracting for coal from other federal leases since 1974, and we have a strong and continuing interest in how the government manages this important energy resource.

We are supplying coal to ten power plants in seven states and are a major purchaser of Powder River Basin coal in Wyoming and Montana. Our coal-using members are consumer-owned utilities, largely rural electric cooperatives and municipal electric systems.

In producing and buying federal coal, we do not want to benefit unfairly at the expense of the citizens of this country who own coal; at the same time, we do not want to pay more than a fair price, and we hope that this Subcommittee will consider the very real possibility that if the government is permitted to assess excessive royalties, not only are coal users likely to turn to non-federal coal or alternate fuels for their energy needs, but the already weakened economies of major western coal states may suffer further setbacks.

The Department of the Interior, through its Minerals Management Service (MMS), has solicited comments and proposals for most of this year, and, going back nearly three years, Western Fuels has suggested different methods than proposed by MMS for doing the necessary job. I trust that the testimony to be given and the questions to be asked will help focus on just what is to be finally proposed by the Department.

Not only is it long past time for these determinations to be made, but it is important that the badly skewed proposal made originally by MMS be corrected to avoid adding a further depressing force to an ailing coal industry. Good, low sulphur western coal today can command prices less than half those that were paid willingly five to seven years ago; the largest single user of coal is the electric utility industry, and the demand for electricity is well below what was forecast in the mid- to late- 1970's.

And, while government officials talk of encouraging domestic production and consumption of coal -- partly as an answer to our growing dependence on foreign oil sources, they continue to act in ways that discourage both domestic production and consumption. It is hard to identify a single instance where government has acted to make domestic coal less expensive, rather than more so.

To try to restore some realism to the procedure under which coal value is established for royalty-setting purposes, Western Fuels petitioned the Secretary of Interior in 1985 to adopt a new set of procedures which would update values every two years on a federal coal production region-by-region basis. I will explain this in some detail later, and provide the petition itself as Attachment A to this testimony.

Having made no headway with the Department the past two and one-half years, Western Fuels earlier this year joined forces with the Edison Electric Institute, the National Coal Association, and the American Mining Congress in proposing still another, and quite simple, procedure. It was a united front, actually, of coal producers and the principal utility users of coal, because in addition to the investor-owned utilities represented by E.E.I., national service organizations of Western Fuels' individual members -- the American Public Power Association (municipals) and National Rural Electric Cooperative Association, also joined in support of this proposal.

There are opponents, of course, of this plan, and you will hear from them, but in addition to finding a simplified method of determining a fair and valid value of coal for royalty setting purposes, we must eliminate the unrealistic and very unfair procedures which let the government put taxes on taxes, royalties on royalties until the so-called "value" is inflated beyond any semblance of reality.

Mr. Chairman, as the Subcommittee knows, 50 percent of federal royalty collections from coal production are returned to the states where the mines are located. But the "value" of the coal, on which royalties are assessed by MMS include black lung excise tax payments, abandoned mine land (AML) reclamation fees, and in many cases state severance taxes and state or local production taxes. Thus the royalties are collected not on a true value of the coal but on the cost of producing it including a reasonable profit plus a variety of federal and state fees and taxes, including the federal royalty cost itself before the final royalty figure is determined.

In a depressed market and a highly competitive situation, this tends to price federal coal out of the market. Royalties paid to holders of privately owned coal generally are less than current federal rates of 12$^{1}/_{2}$ percent for surface-mined coal and 8% for coal produced from underground mines.

Recognition of some of the problems thus created have caused some major coal producing states to lower their severance taxes and to make certain adjustments that lower the value of coal to which the federal royalty is applied. Montana deducts state severance tax (which it has lowered recently) and government royalties before determining severance tax value. And in the largest producer in the West, Wyoming, government royalties are deducted for state severance tax application purposes.

But, while MMS has proposed eliminating black lung fees from the calculation of coal value and AML reclamation fees from the calculation of coal value for royalty purposes, it has left in place state severance tax costs and the federal royalty costs. It is a pity that having recognized the inequity of including some of these extra charges, the federal government refuses to delete others that are equally indefensible.

The joint industry proposal will be fully explained by other witnesses. It was developed, we believe, because of a perception growing out of conversations between industry and the Department of the Interior that if coal producers and coal users could arrive at a common position on a method for determining a simple, defensible valuation of coal for royalty purposes, the Department might accept it.

We believe that the "joint industry proposal" does all that by making use of an already established, universally available, well-defined benchmark as the starting point for the valuation, that benchmark being the gross income from the property as defined by Internal Revenue Service Code Section 613 and related regulations, which is commonly referred to as "depletable income". Depletable income is the arms-length selling price of produced coal F.O.B. the mine and is consistently calculated by coal producers on a mine specific basis.

By contrast, the MMS proposal is based upon gross proceeds of the mining company on a contract-by-contract basis, which makes for a clumsy and time-consuming job of administering and auditing.

The "joint industry proposal" also has two other convincing factors: 1. It uses a fixed valuation point -- that point at which the coal achieves marketable condition. This is when it has been mined, crushed and sized. 2. Valuation adjustments, which eliminate such things as black lung excise tax, abandoned mine land fees, and state severance taxes from the mining companies' gross receipts in arriving at the value of produced coal for royalty calculations.

This is the fair way, and this is a way to collect substantial federal coal royalties without discouraging production of coal from federal leases.

I would like, at this point, to provide the explanation I promised earlier of the alternative plan we proposed to Secretary of the Interior Donald P. Hodel on May 30, 1985. It is clear to all who have viewed the roller-coaster ups and downs of coal prices the past 12 to 14 years that current contract prices are not reflective of true value, nor can contract prices ever be expected to equate a "current value". Contracts are typically long term and contain escalation features; commodity value of coal does not trace escalation in the economy, and, hence, utilization of term contract prices to determine current value is inherently wrong.

What Western Fuels proposed was that value be determined through a biennial regional rulemaking, overseen by the District Mining Supervisors of the Minerals Management Service. The "regions" are the coal production regions as defined by the Department and its pertinent bureaus, offices and services. For purposes of defining the market value or price, we must first define the market: 1) identify the product market; 2) determine the geographic boundaries of the market, and 3) choose the appropriate transactions within both the product and geographic markets in order to set a market price.

This proposed procedure is explained in detail, as noted above, in Attachment A.

In March of this year, we testified in support of this proposed procedure during the MMS hearings in Denver, and that testimony is appended to this as Attachment B. (Appendix A to Attachment A is the proposed rule. Appendix B to Attachment A is a photo-copy of the existing regulations which our rule would change, Appendix C lists existing Conditions of Lease, and Appendix D lists coal tax burdens in seven western states as of last Spring.)

Mr. Chairman, I again want to thank you and the Subcommittee for addressing this problem and for the opportunity to present our views.

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WESTERN
FUELS
ASSOCIATION
INC.
*The National
Fuel Supply
Cooperative*

Fredrick D. Palmer
General Manager

Attachment A

May 30, 1985

Hon. Donald P. Hodel
Secretary of the Interior
U.S. Department of the Interior
Washington, D.C. 20240

Re: Petition for Rulemaking

Dear Mr. Secretary:

Pursuant to the Administrative Procedure Act, 5 U.S.C. § 553(e), and Department of the Interior Regulations, 43 C.F.R. § 14, Western Fuels Association, Inc. hereby petitions for a rulemaking. We propose that the Department of the Interior revise rules governing valuation of coal for the purpose of calculating federal royalties on coal leases. These rules are contained in 30 C.F.R. §§ 203.200(f),(g).

The proposed rule change is attached as Appendix A, and is a complete substitute for 30 C.F.R. § 203.200(g) (Appendix B).

BACKGROUND

The existing rule was promulgated pursuant to the Federal Coal Leasing Amendments Act of 1975, 30 U.S.C. § 207(a). See Appendix C. We believe that the proposed rule is in keeping with Congressional intent, consistent with 30 U.S.C. § 207(a). The statute provides, in relevant part: "A lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12 1/2 per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations." 30 U.S.C. § 207(a) (emphasis added). The regulations issued pursuant to this statute took the unusual step of defining gross value on the basis of "the unit sale or contract price times the number of units sold." 30 C.F.R. § 203.200(g).

This regulatory definition of "value" was specifically rejected by Congress in 1975. Congress accepted the Interior Department's view that a true "value" standard rather than a

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"sales price" standard (now incorporated in the regulations) was most appropriate. As Assistant Secretary of the Interior, Horton testified:

> . . . H.R. 3265 would impose a minimum royalty based on a percent of the sales price of the coal. We recommend deletion of this provision. Royalties are usually based on a percent of the value of the coal rather than the sale price of the coal because coal that is produced is often not actually sold and because the sale price, for one reason or another, may be less than the fair market value. The bill should give the Secretary authority to set a minimum royalty rate, rather than setting a minimum royalty.

Federal Coal Leasing: Hearing on H.R. 3265 Before the Subcommittee on Mines and Mining of the Committee on Interior and Insular Affairs, 94th Cong. 1st Sess. 8, 13, 16 (1975). It is inappropriate for the Department of the Interior to change the market value statutory standard, whether this price is higher or lower than a contract price. The change we recommend would make the regulations consistent with the statute by equating gross value with market price.

DISCUSSION

Value should be determined through a biennial regional rulemaking, overseen by the District Mining Supervisors of the Minerals Management Service. Current contract prices are not reflective of value, nor can contract prices ever be expected to equate to a current value. Coal contracts are typically long term and contain escalation features. Experience has proven that the commodity value of coal does not trace escalation in the economy, for a variety of reasons. Thus, utilization of term contract prices to determine current value is inherently wrong.

For purposes of defining the market value or price, we must first define the market: 1) identify the product market; 2) determine the geographic boundaries of the market; and 3) choose the appropriate transactions within both the product and geographic markets, in order to set a market price. See Brown Shoe Company v. United States, 370 U.S. 294, 323-28, 336-37 (1962).

The product market is measured by the notion of interchangeability; that is, what product could substitute for the product in question. See e.g., United States v. E.I. duPont de Nemours & Co., 351 U.S. 377, 394 (1956). Obviously for purposes of setting price, and thus value, two key factors for coal are Btu content and sulfur content. The geographic boundaries of the market must be set by region of coal production to acknowledge differing transportation costs, coupled of course with the other price factors such as Btu and sulfur content.

There are many problems with the Mineral Management Service's reliance on contract price for setting value. For example, older coal contracts established when coal markets were tight led to prices that are now well above market. Furthermore, contract price escalators are present in many of these contracts which may artificially increase prices even further. Of course some contracts have renegotiation clauses which allow periodic review, but not all have this provision. Key factors in contract price are the length of the contract, the size of the contract, and the age of the contract (what were the market conditions when the contract was signed).

In consideration of the above factors, it would be logical to set market price or value in each of the twelve coal supply regions on the basis of Btu content. For example, three market prices based on 1850 Btu ranges for coal could be set forth for each region: 7000-8850, 8850-10,700, 10,700-12,550. Thus the average price could be based on tons of coal sold/Btu with an average of prices in a region over an appropriate time frame. The development of the rule should favor current prices because that is a more accurate measure of value at any moment than contract prices. The rule must ensure confidentiality of pricing data. In sum, value would be based on an expert evaluation of these factors.

Value certainly does not include any taxes or fees, including severance taxes, black lung tax, reclamation fees, state income or federal income taxes, sales tax, or property taxes. The value of a product does not increase with a tax added to it, only the price increases. As the Linowes Commission found:

> The Commission concluded that the Federal royalty should be based on the value of the coal being produced, not on state and local taxes as well. Federal royalty policies should not create an incentive for higher state and local severance taxes -- or similar production based taxes -- by increasing the effective total return to a given percentage tax. State and local governments should bear the direct responsibility for the full financial impact of their severance taxes.

Report of the Commission - Fair Market Value Policy For Federal Coal Leasing, at 321 (February 1984) (emphasis added).

The Linowes Commission recognized that royalties should not be based on taxes and fees added to the real market value of coal. Such a tax-on-tax situation is inequitable, at the very least. It is obvious that basing federal royalties on the value of coal plus these taxes and fees is not a tax on the "value" of coal as defined by statute, but a royalty on the tax and the value of coal. As can be seen from Appendix D, the tax burden in western coal states is already substantial. The current rule aggravates this tax burden by imposing still higher taxes in the form of a royalty.

The present system is equivalent to what would occur if the federal income tax was imposed on the "value" of your income plus state and local taxes paid, *i.e.*, \$60,000 + \$10,000 in state and local taxes = \$70,000 x federal income tax rate = taxes owed. This obviously would be foolish, and is comparable to the situation we face in this tax-on-tax situation. Thus the regulation must specifically set gross value exclusive of all taxes and fees.

One further argument in support of the rule which we have proposed is that it would ease the burdens imposed by the United States Court for Wyoming in *FMC Wyoming Corp. v. Watt*, 587 F. Supp. 1545 (D. Wyo. 1984). This case, if *upheld* by the Court of Appeals, would require a "complete evaluation of all the factors involved in an individual case," at the time of readjustment. 587 F. Supp. at 1548. If our proposed rule were to be implemented by the Department, then the biennial regional rulemaking would set the value of the coal avoiding a review of each and every factual circumstance surrounding each lease.

CONCLUSION

The high royalty of 12 1/2 per cent in combination with an inflated value based on sales or contract price rather than market price, and finally a tax-on-tax situation, actually reduces federal revenue by serving as an unnecessary and artificial disincentive to coal production. We look forward to positive and rapid action on our petition for rulemaking.

Respectfully submitted,

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FDP/pb
Attachments

APPENDIX A

PROPOSED RULE [1]

30 C.F.R. § 203.200(g). The gross value shall be the unit MARKET [sale or contract] price times the number of units sold [unless MMS determines that]. MARKET PRICE, FOR PURPOSES OF DETERMINING GROSS VALUE, SHALL EXCLUDE ALL STATE, LOCAL, AND FEDERAL TAXES AND FEES. THE MARKET PRICE SHALL BE DETERMINED EVERY TWO YEARS BY RULE IN EACH OF THE TWELVE FEDERAL COAL SUPPLY REGIONS (POWDER RIVER REGION, FORT UNION REGION, GREEN RIVER-HAMS FORK REGION, UINTA-SOUTHWESTERN UTAH REGION, DENVER-RATON MESA REGION, SAN JUAN RIVER REGION, WESTERN INTERIOR REGION, TEXAS REGION, EASTERN INTERIOR REGION, NORTHERN APPLACHIAN REGION, CENTRAL APPLACHIAN REGION, AND SOUTHERN APPLACHIAN REGION).

(1) THE BIENNIAL RULEMAKING SHALL BE CONDUCTED ON A REGIONAL BASIS BY THE DISTRICT MINING SUPERVISORS OF THE MINERALS MANAGEMENT SERVICE IN EACH REGION WHERE FEDERAL COAL ROYALTIES ARE BEING OR ARE EXPECTED TO BE PAID WITHIN THE SUCCEEDING TWO YEAR PERIOD. SUCH RULEMAKING SHALL REQUIRE AT LEAST NOTICE AND COMMENT, AS WELL AS A PUBLIC HEARING IN EACH REGION. SUCH RULE MAY BE APPEALABLE TO THE IBLA. THE DISTRICT MINING SUPERVISOR, IN PREPARATION OF THE RULE, SHALL RECEIVE

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[1] Words in brackets are in the existing rule and are proposed for deletion. Words in capital letters are proposed for inclusion.

TESTIMONY FROM EXPERTS TO ASSIST IN THE ESTABLISHMENT OF MARKET PRICES IN EACH REGION.

(2) THE DISTRICT MINING SUPERVISOR SHALL DETERMINE THE GROSS VALUE OF SUCH COAL IN EACH COAL SUPPLY REGION FOR EACH OF THE FOLLOWING BTU CONTENT RANGES: 7,000-8,850; 8,850-10,700; 10,700-12,550. HE SHALL ALSO TAKE INTO ACCOUNT:

(i) THE AVERAGE SPOT AND TERM MARKET PRICE BID FOR COAL PER TON DURING FOUR QUARTERLY PERIODS PRIOR TO THE ISSUANCE OF THE RULE. THE AVERAGE SPOT AND TERM PRICE SHALL BE THE MOST IMPORTANT FACTOR IN DETERMINING THE MARKET PRICE.

(ii) THE AVERAGE CONTRACT PRICE PAID BY PURCHASERS TO COAL PRODUCERS FOR COAL PER TON, DURING FOUR QUARTERLY PERIODS PRIOR TO THE ISSUANCE OF THE RULE. THE AVERAGE CONTRACT PRICE IS NOT AS IMPORTANT A FACTOR IN DETERMINING MARKET PRICE AS THE AVERAGE SPOT AND TERM MARKET PRICE. TO DETERMINE AVERAGE CONTRACT PRICE, THE DISTRICT MINING SUPERVISOR MAY RELY ON PRICES REPORTED TO A PUBLIC UTILITY COMMISSION AND/OR THE FEDERAL ENERGY REGULATORY COMMISSION. COAL PRODUCERS MAY BE DIRECTED BY THE DISTRICT MINING SUPERVISOR TO SUPPLY SUCH CONTRACT PRICE DATA AS IS REQUIRED.

ucts from the lease; and all other facts tending to show whether the wells can be successfully operated under the royalty or net profit share fixed in the lease. Full information shall be furnished as to whether royalties or payments out of production are paid to anyone other than the United States, the amounts paid, and the efforts made to reduce them. The applicant must also file agreements of the holders of the lease and of royalty holders to a reduction of all other royalties from the leasehold to an aggregate not in excess of one half the revised Government royalty or net profit share that would result if the request for a reduction were allowed.

(c) An application for relief under paragraph (a) of this section shall be filed in triplicate with the Director.

[44 FR 61892, Oct. 26, 1979, 45 FR 20464, Mar. 28, 1980. Redesignated at 48 FR 35641, Aug. 5, 1983]

Subpart E—Coal

§ 203.200 Royalties.

(a) Provisions for the payment of advance royalty in lieu of continued operation are contained at 43 CFR 3483.4.

(b) An overriding royalty interest, production payment, or similar interest that exceeds 50 percent of royalty first payable to the United States under the Federal lease, or when added to any other overriding royalty interest exceeds that percentage, except those created in order to finance a mine, shall not be created by a Federal lease transfer or surface owner consent. However, when an interest in the Federal lease or operating agreement is transferred, the transferor may retain an overriding royalty in excess of the above limitation if he shows that he has made substantial investments for improvements directly related to exploration, development, and mining on the land covered by the transfer that would justify a higher payment.

(c)(1) The District Mining Supervisor may waive, suspend, or reduce the rental on a Federal lease, or reduce the Federal royalty, but not advance royalty, on a Federal lease or portion thereof. The District Mining Supervisor shall take such action for the purpose of encouraging the greatest ultimate recovery of Federal coal, and in the interest of conservation of Federal coal and other resources, whenever in his judgment it is necessary to promote development, or if he finds that the Federal lease cannot be successfully operated under its terms. In no case shall the District Mining Supervisor reduce to zero any royalty on a producing Federal lease.

(2) An application for any of the above benefits shall be filed in triplicate in the office of the District Mining Supervisor. The application shall contain the serial number of the Federal lease, the Bureau of Land Management State Office, the name and address of the record title holder and any operator/lessee, and the description of the lands in the manner provided by 43 CFR 3471.1.

(i) Each application shall include the name and location of the mine; a map showing the extent of the existing, proposed or adjoining mining operations; a tabulated statement of the Federal coal mined, if any, and subject to Federal royalty for the existing or adjoining operation covering a period of not less than 12 months before the date of filing of the application; and existing Federal rental and royalty rates on Federal leases covered by the application.

(ii) Each application shall contain a detailed statement of expenses and costs of operating the entire mine, the income from the sale of coal, and all facts indicating whether the mine can be successfully operated under the Federal rental and royalty provisions fixed in the Federal lease or why the reduction is necessary to promote development. Where the application is for a reduction in Federal royalty, full information shall be furnished as to whether royalties or payments out of production are paid to parties other than the United States, the amounts so paid, and efforts made to reduce them, if any. If the Federal lease included in the application is not part of nor adjoining an operating mine, these detailed financial data may be obtained from another operating mine which is in close proximity and for which the District Mining Supervisor has deemed to have similar operating characteristics.

(iii) The applicant shall also file a copy of agreements, between the operator/lessee and the holders of any royalty interests or production payments other than those created in order to finance a mine, to a reduction of all other royalties from the Federal lease so that the total royalties and production payments owed the holders of these interests will not be in excess of one-half of the Federal royalties, should the Federal royalty reduction be granted.

(3) If the applicant does not meet the criteria of the rules of this Part, the District Mining Supervisor shall reject such application or request more data from the operator/lessee.

(4) If the applicant meets the criteria of the rules of this Part, the District Mining Supervisor shall act on the application.

(d) Operators/lessees shall submit Federal royalty payments as provided for in the Federal lease. The payment shall be made within 30 days after the end of the royalty reporting period for which the royalty accrued.

(e) Where Federal royalty is calculated on a cents-per-ton basis, it shall be based on the actual weight of coal and shall accrue on the sale or use of the coal. In addition, where coal placed in inventory exceeds that which the District Mining Supervisor determines to be required for normal mining and processing operations, the Federal royalty shall also be paid on that excess estimated tonnage in inventory.

(f) Where Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine, except as provided at 30 CFR 203.200(h). For captive operations or other than arms-length transactions, the District Mining Supervisor shall determine gross value and the point of sale.

(g) The gross value shall be the unit sale or contract price times the number of units sold, unless MMS determines that:

(1) A contract of sale or other business arrangement between the operator/lessee and a purchaser of some or all of the coal produced from the Federal lease is not a bona fide transaction between independent parties because it is based in whole or in part upon considerations other than the value of the coal; or,

(2) No consideration is received from some or all of such coal because the operator/lessee is consuming such coal or adding it to inventories, and for which Federal royalty is due and payble.

In either case, MMS shall determine the gross value of such coal taking into account:

(i) Any consideration received or paid by the operator/lessee in other related transactions.

(ii) The average price paid for coal of like quality produced from the same general area during the Federal lease month.

(iii) Contracts or other business arrangements, between coal producers and purchasers for the sale of coal other than coal produced under such Federal lease, which are comparable in terms, volume, time of execution, area of supply, and other circumstances.

(iv) Mining cost plus reasonable profit margin.

(v) Prices reported to a public utility commission and/or the Federal Energy Regulatory Commission.

(vi) Such other relevant factors as the District Mining Supervisor may deem appropriate.

(h) If additional preparation of the coal is performed prior to sale, such costs shall be deducted from the gross value in determining value for Federal royalty purposes. The District Mining Supervisor will allow such deductions only when, in his judgment and subject to his audit, the operator/lessee provides an accurate account of the costs incurred. However, the following shall not be deducted from the gross value in determining value for Federal royalty purposes: costs of primary crushing, storing, and loading; treatment with chemicals to prevent freezing; treatment with oil to suppress dust in transit; and, other preparation of the coal which in the judgment of the District Mining Supervisor does not enhance the quality of the coal.

(i) If a Federal coal lease that provides for a percentage Federal royalty is developed by *in situ* technology, the gross value of production for the purpose of computing royalty shall be determined by MMS.

(j) If a Federal coal lease that provides for a cents-per-ton Federal royalty is developed by *in situ* technology, MMS will establish a procedure for estimating tonnage for royalty purposes.

(k) In the event waste piles or slurry ponds are reworked to recover coal, or if a market becomes available to sell the waste products containing coal, the operator/lessee shall pay Federal royalty at a rate specified in the Federal lease at the time of recovery. The operator/lessee shall make payment based on the Federal share of the coal when the coal is recovered regardless of whether it is stored on Federal lands. Where such waste containing coal from a Federal lease is mixed with similar waste from private lands, the operator/lessee shall maintain accurate records from which Federal ownership of coal in the waste may be determined. However, nothing in this section requires payment of a Federal royalty on Federal coal for which a Federal royalty has already been paid.

[48 FR 35642, Aug. 5, 1983]

Subpart F—Other Solid Minerals—[Reserved]

Subpart G—Geothermal Resources—[Reserved]

Subpart H—Indian Lands—[Reserved]

PART 206—PRODUCT VALUATION

Subpart A—General Provisions—[Reserved]

Subpart B—Oil and Gas, General—[Reserved]

Subpart C—Oil and Gas, Onshore

Sec.
206.100 Waste prevention, beneficial use.
206.101 Determination of gasoline content of natural gas.
206.102 Quantity basis for computing royalties on natural gasoline, butane, propane, and other liquid hydrocarbon substances extracted from gas.
206.103 Value basis for computing royalties.
206.104 Royalty rates on oil; sliding- and step-scale leases (public land only).
206.105 Royalty on gas.
206.106 Royalty on casing head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from gas.
206.107 Royalty on drip gasoline or other natural condensate.

Subpart D—Oil, Gas and Sulphur, Offshore

206.150 Value basis for computing royalties.
206.151 Royalty on unprocessed gas.
206.152 Royalty on processed gas and constituent products.

Subpart E—Coal—[Reserved]

Subpart F—Other Solid Minerals—[Reserved]

Subpart G—Geothermal Resources

206.300 Value of geothermal production for computing royalties.
206.301 Computation of ruyalties.

Subpart H—Indian Lands—[Reserved]

AUTHORITY: The Act of February 25, 1920 (30 U.S.C. 181, et seq.) as amended, the Act of May 21, 1930 (30 U.S.C. 301-306), the Mineral Leasing Act for Acquired Lands (30 U.S.C. 351-359), as amended; the Act of March 3, 1909 (25 U.S.C. 396), as amended; the Act of May 11, 1938 (25 U.S.C. 396a-396q), as amended; the Act of February 28, 1891 (25 U.S.C. 397), as amended, the Act of May 29, 1924 (25 U.S.C. 398), the Act of March 3, 1927 (25 U.S.C. 398a-398e), the Act of June 30, 1919 (25 U.S.C. 399), as amended; R.S. § 441 (43 U.S.C. 1457); see also Attorney General's Opinion of April 2, 1941 (40 Op. Atty. Gen. 41); the Federal Property and Administrative Services Act of 1949 (40 U.S.C. 471 et seq.), as amended, the National Environmental Act of 1969 (42 U.S.C. 4321 et seq.), as amended, the Act of December 12, 1980 (Pub. L. 96-514, 94 Stat. 2964); and the Hydrocarbon Leasing Act of 1981 (Pub. L. 97-78, 95 Stat. 1070); the Outer Continental Shelf Lands Act (43 U.S.C. 1331, et seq.) as amended, the Geothermal Act of 1970 (30 U.S.C. 1001 et seq.), as amended; section 2 of Reorganization Plan No. 3 of 1950 (64 stat. 1262); Secretarial Order No. 3071 of January 19, 1982, as amended, and Secretarial Order No. 3087, as amended.

APPENDIX C

§ 207. Conditions of lease

(a) Term of lease, annual rentals; royalties; readjustment of conditions

A coal lease shall be for a term of twenty years and for so long thereafter as coal is produced annually in commercial quantities from that lease. Any lease which is not producing in commercial quantities at the end of ten years shall be terminated. The Secretary shall by regulation prescribe annual rentals on leases. A lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12½ per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations. The lease shall include such other terms and conditions as the Secretary shall determine. Such rentals and royalties and other terms and conditions of the lease will be subject to readjustment at the end of its primary term of twenty years and at the end of each ten-year period thereafter if the lease is extended.

(b) Diligent development and continued operation; suspension of condition on payment of advance royalties

Each lease shall be subject to the conditions of diligent development and continued operation of the mine or mines, except where operations under the lease are interrupted by strikes, the elements, or casualties not attributable to the lessee. The Secretary of the Interior, upon determining that the public interest will be served thereby, may suspend the condition of continued operation upon the payment of advance royalties. Such advance royalties shall be no less than the production royalty which would otherwise be paid and shall be computed on a fixed reserve to production ratio (determined by the Secretary). The aggregate number of years during the period of any lease for which advance royalties may be accepted in lieu of the condition of continued operation shall not exceed ten. The amount of any production royalty paid for any year shall be reduced (but not below 0) by the amount of any advance royalties paid under such lease to the extent that such advance royalties have not been used to reduce production royalties for a prior year. No advance royalty paid during the initial twenty-year term of a lease shall be used to reduce a production royalty after the twentieth year of a lease. The Secretary may, upon six months' notification to the lessee cease to accept advance royalties in lieu of the requirement of continued operation. Nothing in this subsection shall be construed to affect the requirement contained in the second sentence of subsection (a) of this section relating to commencement of production at the end of ten years.

(c) Operation and reclamation plan

Prior to taking any action on a leasehold which might cause a significant disturbance of the environment, and not later than three years after a lease is issued, the lessee shall submit for the Secretary's approval an operation and reclamation plan. The Secretary shall approve or disapprove the plan or require that it be modified. Where the land involved is under the surface jurisdiction of another Federal agency, that other agency must consent to the terms of such approval.

(As amended Aug. 4, 1976, Pub.L. 94-377, § 6, 90 Stat. 1087.)

1976 Amendment. Subsec. (a). Pub.L. 94-377 designated existing provisions as subsec. (a) and as so designated, substituted provisions limiting the lease term to 20 years and for so long thereafter as coal is produced, annually in commercial quantities for provision authorizing leases for indeterminate periods upon condition of diligent development and continued operation except for strikes, the elements, or casualties not attributable to lessees, provisions for payment of royalties as determined by the Secretary of not less than 12½ per centum of coal value, except as reduced for coal from underground mining operations for provisions specifying royalties as stated in the lease, but not less than 5 cents per ton, provision for rentals as prescribed by regulation for provision setting rentals as fixed by the Secretary at not less than 25 cents per acre for the first year, 50 cents for the second, third, fourth and fifth years, and $1 for each year thereafter, and provision for readjustment of royalties and terms and conditions after primary period of twenty years and subsequent ten year intervals for provision for readjustment after twenty years unless otherwise provided by law.

Subsecs. (b) and (c). Pub.L. 94-377 added subsecs. (b) and (c).

Legislative History. For legislative history and purpose of Pub.L. 94-377, see 1976 U.S.Code Cong. and Adm.News, p. 1943.

Notes of Decisions

Adjustment of lease terms 6
Commercial quantities 5
Conditions precedent 1
Interest 3

APPENDIX D

THE TAX BURDEN IN SEVEN WESTERN STATES

(Taxes and Royalties as Percent of Selling Price 1/)

	Surface Mines					Underground Mines	
	Colorado	Montana	New Mexico	N.Dakota	Wyoming	Colorado	Utah
Severance Tax	2.93	21.42	6.44	5.96	10.50	1.03	0.00
Property Tax	1.99	7.16	0.64	0.18	5.93	1.32	1.30
Sales Tax	0.38	N.A.	0.38	0.36	0.27	0.32	0.43
State Income Tax	0.49	0.48	0.57	1.07	N.A.	0.46	0.43
State Subtotal	5.79	29.06	8.03	7.57	16.70	3.13	2.16
Black Lung Tax	1.88	3.01	3.19	N.A.	3.33	2.70	3.94
Reclamation Fee	1.31	2.11	2.23	0.60	2.33	0.40	0.59
Federal Income Tax	4.35	2.83	3.95	12.40 2/	3.73	4.02	4.61
Federal Subtotal	7.54	7.95	9.37	13.00	9.39	7.12	9.14
TOTAL TAXES	13.33	37.01	17.40	20.57	26.09	10.25	11.30
Royalties 3/	12.50	12.50	12.50	12.50	12.50	8.00	8.00

1/ Based on a 10 percent discounted cash flow rate of return over twenty years of production for a new mine with geologic conditions and coal rank typical of each State. The same mine is used for Montana and Wyoming.

2/ Federal income tax is higher in this mine because a higher level of net income is required to offset capital expenditure in the initial years.

3/ Royalty rate for Federal lands.

Source: Gennifer Sussman, "The Energy Tax Burden in Western States: Policy Implications of 1983 Coal Taxation," Colorado Energy Research Institute, Denver, Colorado (1983).

Report of the Commission - Fair Market Value Policy for Federal Coal Leasing, at 323 (February 1984).

Attachment B

REVISION OF COAL ROYALTY VALUATION REGULATIONS AND RELATED TOPICS

Testimony of

FREDRICK D. PALMER

General Manager
Western Fuels Association, Inc.

Presented by:

Don L. Deardorff
Manager - Engineering & Exploration

Minerals Management Service
Public Hearing
March 3, 1987
Denver, Colorado

MR. CHAIRMAN: Western Fuels Association is a not-for-profit fuel supply cooperative incorporated under the laws of Wyoming. Western Fuels and its wholly-owned subsidiaries supply coal at cost to its members, which consist of consumer-owned electric utilities. Western Fuels' membership includes rural electric generation and transmission cooperatives, municipal utilities, and public bodies; as contrasted with investor-owned utilities.

Western Fuels Association is particularly interested in this proposed rulemaking because in different contexts our fuel supply cooperative functions both a lessee of Federal coal reserves and as a purchaser of leased coal. As coal purchasers, we are party to "arm's-length" contracts. As suppliers, we are party to "non-arm's-length" coal supply contracts.

For these reasons: our not-for-profit nature, function as both a purchaser and supplier of Federal leased coal, and our experience with arm's-length and non-arm's-length contracts, we believe our comments should have special cogency for this panel.

I last presented testimony on this topic on March 19, 1986. It was preceded by a petition to Secretary of Interior Hodel dated May 30, 1985. Some of Western Fuels' concerns have subsequently been addressed; the bulk have been ignored.

Proposed §206.251 - Definitions

We continue to believe it is unfair for the royalty to be assessed on the basis of "gross proceeds" rather than using a more accurate determination of "true value" as determined by a biennial regional rulemaking within each federal coal production region. I have twice made this argument. It has twice been ignored.

In Proposed §206.259(f) MMS restates its "longstanding principle that under no circumstances can the value, for royalty purposes, be less that the gross proceeds accruing, or which could accrue, to the lessee, less applicable washing and transportation allowances."

The inequity of this approach, when coupled with the grossly unfair procedure of adding various taxes and fees to the basic cost of producing coal before calculating the royalty, will further depress the coal market.

Conditions in the coal market are not better than when I testified last year. They are worse. Both the Montana and Wyoming legislatures now contemplate reduction of their state severance taxes in order to stimulate production. In this context it is those states, not the federal government, which are reacting to real market forces concerning relative "values" of coal. I believe Montana and Wyoming recognize that reduced severance taxes may reduce potential revenues, but I refuse to believe they are so cynical as to do so in expectation of their 50% share of the increased Federal royalty more than making up the difference.

In the face of this, MMS summarizes its purpose in the revision of coal product valuation this way:

> MMS believes the proposed valuation methods would yield a reasonable and long-term maximum rate of return for both Federal and Indian leases. The basic premise underlying this methodology is that value is best determined by the interaction of competing market forces.

and goes on to state:

> This would add certainty to the market place and assure maximum, long-term revenues to all parties concerned.

While it is clear the MMS construction of valuation on the basis of gross proceeds is intended to maximize revenues for the Federal Treasury, affected States, and Indian tribes, it is incorrect to represent this proposed rule to be sensitive to interactive market forces. It is not market sensitive because it is pegged to a flawed definition of "value". "Gross proceeds" do not represent true value.

Gross proceeds as presently defined by the MMS consist of the commodity sales price plus taxes and assessments. These certainly do not represent value. Their inclusion in fact destroys the concept of commodity "value". The royalty becomes, in part, a tax upon taxes.

It is this flawed linkage which undermines any claim to market sensitivity. It enables the government to collect higher royalties in addition to higher taxes, not because the value of the coal product has been enhanced by the lessee's "negotiation of the best deal to further his own interests", but because government (local, State, or Federal) decides to assess higher taxes. This has nothing to do with the market place.

An increase in taxes has the effect of increasing the royalty, thus accruing double benefits to the government. By our calculation this tax upon a tax in essence increases the 8 percent royalty on underground-mined tonnage to 8.64 percent and increases the 12.5 percent royalty on surface tonnage to 14.0625 percent. This seems inconsistent with congressional intent.

Although Western Fuels is encouraged by the partial validation of such concerns by the redrafting of the definition of gross proceeds to potentially eliminate reimbursements for black lung fees and abandoned mined land fees, we do not believe this goes far enough. At minimum, we support elimination of these two reimbursements from the definition.

A defensible definition of gross proceeds would also eliminate any and all government taxes levied on the volume or value of the coal. We propose State severance and ad-valorem or similar production related taxes be excluded from calculation of gross proceeds.

More than our logic compels deletion of these items. In its Section-by-Section Analysis of the proposed rule, MMS states:

> The definition of gross proceeds is intended to be expansive to ensure that it includes all benefits flowing from the purchaser to, or on behalf of, the seller for the disposition of the coal.

Our objection centers upon the concept of "benefits flowing to the seller".

State severance taxes, ad-valorem or similar production related taxes, black lung, and mined land reclamation fees can not be construed as "benefits flowing to the seller" except for the fact the seller is compelled to collect them and pass them on to the beneficiaries of such taxes and fees.

Although Western Fuels remains convinced that the proposal we have previously made concerning determination of market price as a measure of value is superior to calculation of gross proceeds, in view of the above, we propose gross proceeds be computed as follows once the commodity sale price is known:

Gross Proceed = Sales Price - Black Lung Tax - Reclamation Fee - Production Tax based on value (a precentage of gross proceeds) - Production Tax based on tonnage ($/ton) - Royalty

GP = SP - BL - RecFee - Rate1 - PTax - Rate2

Where:

GP = Gross Proceeds Per Ton
SP = Sale Price Per Ton
BL = Black Lung Tax Per Ton
PTax = Production Tax Per Ton
RecFee = Reclamation Fee Per Ton
Rate1 = Production Tax Rate (percentage of gross proceeds)
Rate2 = Royalty Rate (percentage of gross proceeds)

$$GP(1 + Rate1 + Rate2) = SP - BL - RecFee - PTax$$

$$GP = \frac{SP - BL - RecFee - PTax}{1 + Rate1 + Rate2}$$

For example, if the sales price is $20 per ton, black lung tax is $1.10/ton, reclamation fee is $0.15/ton, production tax is $0.40/ton, production tax based upon value (Rate1) is zero, and the royalty rate (Rate2) is 8 percent, the gross proceeds per ton will be:

$$GP = \frac{20 - 1.10 - 0.15 - 0.40}{1 + 0 + 0.08}$$

$$= \frac{18.35}{1.08}$$

$$= \$16.99 \text{ per ton}$$

The sales price of $20.00 per ton will thus include:

Gross Proceeds	$ 16.99
Black Lung Tax	1.10
Reclamation Fee	0.15
Production Tax	0.40
Royalty	1.36
TOTAL	$ 20.00

It will be helpful in clarifying this issue if MMS will include in the rules some example of the methodology used to compute gross proceeds. At least two situations should be addressed: where value is based upon an arm's-length contract or market value and, also, where value is based upon a non-arm's-length contract or an actual cost basis.

Despite Western Fuels' recommendation of this kind of formulation, we continue to believe our original proposal concerning market price determination is superior to this method.

Proposed §206.255

Coal Subject to Royalties - General Provisions

This section discusses royalty on coal recovered from waste piles or slurry ponds. Under the proposed rule, the royalty rate will be the rate applicable to the production method used initially to mine the coal recovered from the waste pile or slurry pond. MMS should address the possible situation where waste piles and slurry ponds may contain coal produced using both underground and surface methods.

Proposed §206.259 - Valuation Standards for Ad Valorem Leases

Subsection (c) concerns the value of coal not sold under an arm's-length contract. The thrust of the proposed rule is to value coal on the basis of gross proceeds or the market value, whichever is greater, so that the royalty is maximized. Western Fuels believes the primary criterion used to value coal should be "market value of coal of similar quality in the area".

The gross proceeds accruing to a lessee under a non-arm's-length contract do not necessarily represent the "value" of coal. The more difficult the mining conditions, the greater the operating costs. Increased operating costs render the coal product less competitive in the market place. Thus, if coal value is subsequently equated with reimbursement to the lessee by the coal buyer, the ad-valorem royalty is higher for coal mined with greater difficulty. The effect of the higher royalty renders the coal product even less competitive, still.

Under the proposed rule, it appears that the market value of coal must be substantiated before a coal valuation method is formally accepted by MMS. This raises two questions. How often is market valuation to be performed (on monthly basis, quarterly, annually)? Is MMS going to utilize its own data file or will it rely on a third-party market study?

Subsection (f) states, "...under no circumstances shall the value for royalty purposes be less than the gross proceeds accruing or which could accrue to the lessee less applicable allowances...". If the recommendation we have made relative to subsection (c) is adopted, this language should be eliminated as it is thereby rendered inconsistent.

Subsection (h) states, "...after MMS issues a value determination..., the payer is required to pay any additional royalty due plus interest...". However, "...if the lessee is entitled to a credit, ... MMS shall not pay interest on any credit".

For the sake of consistency and fundamental fairness, the interest payment should either apply in both cases or in neither. A possible compromise might be that interest charges will not apply if recomputation of the royalty occurs within a certain timeframe set in advance by MMS.

Proposed §206.260 - Washing Allowances

Subsection (b)(2)(V) discusses the cost of washing and how it can be excluded from the "value" of washed coal for royalty purposes.

MMS should be aware that a major cost component of coal washing is interest on the loans incurred for construction of the washing facility. This can be a substantial cost item for a highly-leveraged company.

Western Fuels proposes that interest cost be included along with depreciation and a return on the undepreciated capital as a first alternative, or, alternatively, with a return on the total capital investment.

Subsection (b)(2)(V)(E) contains MMS' proposal that the rate of return on capital invested will be "... the Moody Aaa corporate bond rate as published by Moody's Investment Service, Inc., in Moody's Bond Record on the first business day of the reporting period for which the allowance is applicable".

The proposed rate of return is far from that desired for a mining operation. The proposed rate is that for investment in the least risky corporate bonds and as MMS should know, mining is a risky venture.

The rate of return should take into account the actual interest rate on borrowed capital as well as a reasonable return on the equity portion of the capital. These rates will vary from company to company -- just as other cost items vary among them. Western Fuels proposes that the rate of return be at least equal to the cost of borrowed capital in the case of a totally leveraged company, and be an average rate weighted with the debt and equity portion of the capital for other companies. The rate of return on the equity portion should be an average for the industry or the rate on Treasury bills, plus five percent, to compensate for associated risk.

Subsection (d) contains a proposal that additional royalties based upon adjustments be paid with interest. However, any credit due to the lessee will not accrue any interest. We again propose that the interest clause either be eliminated or applied in both cases.

Proposed §206.262 - Transportation Allowances

In subsection (a) MMS proposes authorization of a transportation allowance for coal with a point of sale remote from the mine or lease. Now allowance is authorized for in-mine transportation.

Western Fuels proposes that MMS be more explicit as to the definition of "remote" and "in-mine" transportation. The criteria demands clear definition. As they stand, they rely on MMS' subjective judgment.

Subsection (b) limits the transportation allowance to 50 percent of the value of the transported coal. MMS must know that unless coal is sold f.o.b. mine, there are instances where transportation costs are several times the value of the coal. Transportation costs associated with Powder River Basin coal are a good example.

Subsection (d)(2)(V) deals with the determination of transportation allowances and relate to interest payments. Western Fuels reiterates its concern that interest be paid in both instances or neither.

Subsection (d)(2)(V)(E) concerns the rate of return on capital investment. Our concern in this subsection is identical to that expressed under §206.260(b)(2)(V)(E).

Subsection (f) again concerns adjustments relating to interest charges and we again propose their elimination or inclusion in both cases.

MR. CHAIRMAN: This concludes my testimony. Western Fuels Association appreciates the opportunity provided by the Minerals Management Service to let our views be known.

FEDERAL COAL ROYALTY VALUATION

COMPARATIVE IMPACT ANALYSIS

OF

MINERALS MANAGEMENT SERVICE VALUATION PROPOSAL

AND

JOINT COAL/UTILITY INDUSTRY VALUATION PROPOSAL

BY

NATIONAL COAL ASSOCIATION

NOVEMBER 16, 1987

PROJECTED 1990 FEDERAL COAL ROYALTY VALUATION
FISCAL IMPACT ANALYSIS

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FEDERAL COAL ROYALTY VALUATION
PROJECTED 1990 COMPARATIVE ANALYSIS

The purpose of this analysis is to eliminate as much confusion as possible surrounding the nature and fiscal impact of the MMS coal royalty valuation proposal as compared to the joint industry coal royalty valuation alternative. Specifically, the attached detail achieves two objectives:

1. Provides convincing evidence of the invalidity of the MMS fiscal impact analysis which was provided to representatives of the Governors of the six coal-producing states September 28, 1987.

2. Realistically projects 1990 fiscal impact of each proposal using reasonable assumptions that are not driven by the desire to generate the greatest possible impact attributable to the industry proposal.

This analysis does not attempt to measure market sensitivity, or the shift away from federal coal as ad valorem royalty rates and valuation policies take effect. The scope is limited to a comparative impact of the MMS and Industry valuation proposals.

Numerous errors in judgment, mechanics and arithmetic are identified in the attached detail related to the MMS impact analysis. Some of the most glaring problems are identified as follows:

1. The base period used by MMS to project revenue and fiscal impact through 1991 was the first half of the 1987 production year as reported by federal lessees. This means that unusual fluctuations, which were many, during the first half of 1987 will be carried through into all future years' projections. This problem alone renders the resulting impact analysis essentially useless.

2. In virtually every state calculation, a different production or price basis was used for impact calculations related to gross royalty, black lung excise tax, abandoned mine land fees and state severance tax.

3. The impact of eliminating royalty compounding was grossly overstated often by as much as 100%, and in one state by more than 400%.

4. Several state severance tax rates used in MMS projections were substantially in error.

5. A "phantom" excise tax was calculated by MMS as a deduction under the industry proposal, when in fact no such tax exists and no proposal has ever been advanced to deduct this nonexistent tax.

A

In an apparent effort to make critical evaluation of the MMS impact analysis difficult, the base year production and price levels were withheld from the published analysis. As a result, those attending the September 28 meeting did not have enough information to fairly analyze the material provided, then or later.

The attached "revised" 1990 fiscal impact is accompanied by a complete set of sources, assumptions and calculations so that all interested parties can make judgments as to the validity of the results. We do not suggest that all assumptions are inviolate, nor do we suggest that, given the shortness of time, all calculations are 100% accurate. In fact, we solicit any input from interested parties which would help to further refine this analysis. We do say without hesitation that the quality of the revised projection far surpasses anything previously produced.

Hopefully, this analysis will pave the way toward the elimination of the confusion surrounding fiscal impact, so that attention can be focused upon substantive and critical valuation issues.

Summary page C identifies the MMS overstatement of the fiscal impact of the Industry Proposal on a state by state basis.

Summary pages D and E compare MMS impact with NCA revised estimates on an issue by issue basis.

9/034

IMPACT OF INDUSTRY PROPOSAL

	MMS Calculation (Pages 59 through 65)		Revised Calculation (Pages 1 through 48)	
	Total	State Share	Total	State Share
Colorado	$ 6.700	$ 3.350	$ 3.119	$ 1.560
Montana	11.240	5.620	7.535	3.768
New Mexico	2.600	1.300	2.611	1.306
North Dakota	3.920	1.960	1.925	.963
Utah	6.980	3.490	2.767	1.384
Wyoming	35.770	17.740(A)	20.517	10.259
(C) Totals	$67.090(B)	$33.545(B)	$38.474	$19.240

(A) MMS impact for Wyoming state share does not equal 50% of total.

(B) Columns do not add correctly due to MMS rounding.

(C) Based on the above summary, MMS overstated the 1990 fiscal impact of the Industry Proposal by $28.576 million, or 74%.

These impact numbers conflict with the comment in the MMS study (page 52 of this document) that "there could be a decrease in federal coal royalty revenue receipts of about $80 million per annum for calendar year 1990 production" if the Industry Proposal is adopted. This is an overstatement of the impact by $41.526 million or 120%.

Another set of impact numbers found in the MMS study (pages 53 and 54 of this document) purport the 1990 impact of the Industry Proposal to be $33.445 million. This is an understatement of the impact by $5.029 or 13%.

None of the MMS conflicting impact measurements appears to be realistic.

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
SIX STATE SUMMARY

(Amounts in millions except per ton prices and royalty rates)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$ 15.853			$ 10.700		
B)	Projected Ad Valorem Production (Tons)	121.344			148.300		
C)	Projected Ad Valorem Gross Receipts	$1,923.666			$1,586.785		
D)	Projected Ad Valorem Royalty		$218.310	**$109.155**		$180.051	**$90.026**
E)	Projected $/ton Royalty:						
	Tons	-0-			$ 27.000		
	Rate	-0-			.202		
	Royalty		-0-	**-0-**		5.460	**2.730**
F)	Total Projected Royalty		$218.310	**$109.155**		$185.511	**$92.756**
G)	Black Lung Excise Tax	(69.354)	(7.890)	**(3.945)**	(59.449)	(6.699)	**(3.349)**
H)	Abandoned Mine Land Fee	(43.877)	(5.320)	**(2.660)**	(46.056)	(5.617)	**(2.808)**
I)	Projected Royalty - MMS Proposal	$1,710.442	$205.100	**$102.555**	$1,481.280	$173.195	**$86.599**
J)	Royalty on Itself	(240.337)	(26.900)	**(13.450)**	(129.260)	(14.856)	**(7.429)**
K)	Post Mkt. Cond. Handling Value	(104.852)	(11.800)	**(5.900)**	(63.453)	(7.200)	**(3.601)**
L)	State and Local Sev./Prod. Tax	(191.121)	(23.700)	**(11.850)**	(132.174)	(16.418)	**(8.210)**
M)	Other	(39.914)	(4.690)	**(2.345)**	-0-	-0-	**-0-**
N)	Projected Royalty - Industry Proposal	$1,134.218	$138.010	**$ 69.010**	$1,156.393	$134.721	**$67.359**
O)	Difference Between MMS & Ind. Proposal		$ 67.090*	**$ 33.545***		$ 38.474	**$19.240**

*Summary of MMS state by state calculations from pages 59 through 65 of this document

PROJECTED 1990 FEDERAL ROYALTY COMPARISON

SIX STATE SUMMARY EXPLANATION

A) Projected 1990 Weighted Average Price of Federal Coal. See state calculations for detail.

B) Projected 1990 production in tons from all federal leases.

C) Projected 1990 Gross Receipts (from following six state schedules).

D) Projected 1990 Ad Valorem Royalty:
Surface @ 12.5%
Deep @ 8.0%

E) Projected 1990 $/ton royalty @ $.20/ton, except for a small amount in Montana which is approximately $.24/ton.

F) Total 1990 projected Ad Valorem and $/ton royalty before any deductions.

G) Black Lung Excise Tax computed @ 4.4% of selling price reduced by Black Lung Excise Tax, subject to caps of $1.10 for deep coal and $.55 for surface coal. Black Lung Excise Tax does not apply to lignite.

H) Abandoned Mine Land Fee:
$.35/Ton for Surface Coal
.15/Ton for Deep Coal
.10/Ton for Lignite

I) Total 1990 projected royalty after deduction from value of Black Lung Excise Tax and Abandoned Mine Land Fees (MMS Proposal).

J) Effect of removing the royalty to prevent compounding.

K) To remove the value of handling or processing occurring after coal has achieved marketable condition under the Industry Proposal. (This adjustment also referred to as a "processing allowance")

L) To remove state and local severance tax pursuant to the Industry Proposal. (See individual state schedules for detail.)

M) MMS refers to an excise tax applicable to coal, other than Black Lung Excise Tax. There is no such tax. Therefore, it cannot be deducted.

N) Total 1990 projected royalty after all deductions.

O) Total 1990 projected net difference in royalty revenue between the MMS Proposal and the Industry Proposal.

9/033

E

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION

COLORADO

1) The MMS analysis of the impact of the Industry Proposal was released without reference to the actual price and production assumptions, thus making it extremely difficult to evaluate the validity of the results. However, certain things are known about how MMS proceeded. MMS assumed prices would not change in the 1987-1991 time frame. It also used lessee reported data by lease for the first half of calendar year 1987 (multiplied by 2) as the base year. Since MMS elected not to divulge actual price and production assumptions, and it suggests that prices are "flat", MMS price assumptions should not depart substantially from 1986 levels as found in Exhibit A and The 1986 Report on Receipts from Federal and Indian Lands, published by the U.S. Dept. of Interior.

   If MMS used something close to the $18.92 actual 1986 price as representative of the 1990 price per ton (Exhibit A), in calculating total royalty revenue before deductions to be $18.7 mm (Exhibit B), and the deep/surface relationship of 38%/62% found in EIA, Coal Production 1985, Table 2 was used, the resulting 1990 annual production would be 9.559 mm tons.

   ($18.7 mm ÷ 10.79%* = $173.309 mm ÷ $18.92 = $9.160 mm tons)
   *38% Deep @ 8.0%, 62% Surface @ 12.5% = 10.79% Weighted Average.

   We believe this assumption projects modestly optimistic results for 1990. The continued soft coal market, coupled with increased competition from other sources and a proportionately high cost of production (including the federal royalty), will depress Colorado coal production from the 1986 level of 10.296 mm tons to 8.5 mm tons by 1990.

2) Too much information was withheld by MMS to reasonably analyze its Black Lung Excise Tax and Abandoned Mine Land Fee calculations. It does appear that different price and tonnage assumptions were used for each.

3) The impact of deducting federal royalty is grossly overstated by MMS, perhaps by as much as 300% (based on MMS assumptions). MMS calculates 1990 federal royalty under the Industry Proposal to be $10.8 mm (Exhibit B), yet it deducted royalty in excess of $30 mm to arrive at the impact of this portion of the Industry Proposal.

4) The impact of the so-called "processing allowance" proposed by the coal/utility industry to remove value added after marketable condition has been achieved has also been substantially overstated by approximately 100%. A reasonable estimate of the value of post marketable condition handling and/or processing is 4% of selling price for Colorado coal. Based on MMS price and production levels, the correct impact would be $.748 mm, not $1.5 mm. ($173.30 mm x 4% = $6.932 mm x 10.79% = $.748 mm)

5) MMS overstated the impact of deducting state severance tax by apparently using the higher "surface" rate of $.799/ton (Exhibit A), ignoring the fact that "deep" coal accounts for approximately 1/3 of total production and is taxed at a lower rate ($.40/ton). A more realistic measure of the impact of this deduction based on MMS production assumptions is $.633 mm, not $1.2 mm. (.64 x 9.16 mm tons = $5.862 mm x 10.79% = $.633)

6) MMS indicates in Exhibit B that another excise tax applies to coal (in addition to the Black Lung Excise Tax), and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

9/009

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
COLORADO
(Amounts in millions except per ton prices and royalty rates)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$ 18.920			$ 22.920		
B)	Projected Ad Valorem Production (Tons)	9.160			8.500		
	Projected Ad Valorem Gr. Receipts (AxB)	$173.307			$194.820		
C)	Projected Ad Valorem Royalty @ *%		$18.700	$9.350		$20.534	$10.267
D)	Black Lung Excise Tax	(7.414)	(.800)	(.400)	(6.213)	(.655)	(.327)
E)	Abandoned Mine Land Fee	(3.707)	(.400)	(.200)	(2.236)	(.236)	(.118)
	Projected Royalty - MMS Proposal	$162.186	$17.500	$8.750	$186.371	$19.643	$ 9.822
F)	Royalty on Itself	(32.437)	(3.500)	(1.750)	(16.524)	(1.742)	(.871)
G)	Post Mkt. Cond. Handling Value	(13.902)	(1.500)	(.750)	(7.793)	(.821)	(.411)
H)	State and Local Sev./Prod. Tax	(11.121)	(1.200)	(.600)	(5.273)	(.556)	(.278)
I)	Other	(4.634)	(.500)	(.250)	-0-	-0-	-0-
	Projected Royalty - Industry Proposal	$10C.092	$10.800	$5.400	$156.781	$16.524	$ 8.262
	Difference Between MMS & Ind. Proposal		$ 6.700	$3.350		$ 3.119	$ 1.560

*Weighted Average MMS 10.79%, Revised 10.54%

NOTE -- Sources, assumptions and calculations explained on following page.

9/019

PROJECTED 1990 FEDERAL ROYALTY COMPARISON - COLORADO

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Price will increase from $18.92 in 1986 to $22.92 by 1990 due to high and rising production costs (including government levies) coupled with long term contractual arrangements.

B) Significant production will be displaced by lower cost production from the Powder River Basin and other relatively lower cost sources, dropping Colorado federal coal production to 8.5 mm tons by 1990.

C) Assumed a weighted average royalty rate of 10.54% applicable to all production.

D) Black Lung Excise Tax Calculation:
1990 Projected Surface Tons of 4.803 mm @ $.55 = $2.642 mm
1990 Projected Deep tons of 3.697 mm @ $\frac{\$22.92}{104.4\%}$ x 4.4% = 3.571 mm
Total Tax $6.213 mm
Royalty Impact @ 10.54% = $ .655 mm

E) Abandoned Mine Land Fee Calculation:
1990 Projected Surface Tons of 4.803 @ .35 = $1.681 mm
1990 Projected Deep Tons of 3.697 @ .15 = .555 mm
Total Fee $2.236 mm
Royalty Impact @ 10.54% = $ .236 mm

F) Royalty on Itself Calculation:
Royalty Per Industry Proposal of $16.524 mm x 10.54% = $1.742 mm

G) Post Marketable Condition Handling Value Calculation:
Gross Receipts of $194.82 mm x 4% = $7.793 x 10.54% = $ .821

H) State and Local Severance Tax Calculation:
1990 Projected Surface Tons of 4.803 mm @ $.79 = $3.794 mm
1990 Projected Deep Tons of 3.69 mm @ $.40 — = 1.476 mm
Total Tax $5.270 mm
Royalty Impact $ .556 mm

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1985 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deductic
Colorado	$18.92 (Deep & surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.2 21.46%/17.
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.069 4.50%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.76	$1.47 12.5%	$1.08 9.17%	$0.10 0.85%	$ 0 0%	$2.65 22.50%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

A

5 EXHIBIT A

FEDERAL COAL LEASES
STATE OF COLORADO

CAST AR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: STATE SHARE
987	$ 16,580,000 Includes Reimbursement for Black Lung $ 780,000 AML $ 340,000	$ 8,290,000				
988	$ 17,480,000 Includes Reimbursement for Black Lung $ 760,000 AML $ 360,000	$ 8,740,000	$ 16,360,000 Excludes Reimbursement for Black Lung $ 760,000 AML $ 360,000	$ 8,180,000		
989	$ 18,340,000 Includes Reimbursement for Black Lung $ 790,000 AML $ 390,000	$ 9,170,000	$ 17,160,000 Excludes Reimbursement for Black Lung $ 790,000 AML $ 390,000	$ 8,580,000		
990	$ 18,700,000 Includes Reimbursement for Black Lung $ 800,000 AML $ 400,000	$ 9,350,000	$ 17,500,000 Excludes Reimbursement for Black Lung $ 800,000 AML $ 400,000	$ 8,750,000	$ 10,800,000 Excludes Reimbursement for Severance/prod. tax $ 1,200,000 Processing All. $ 1,500,000 Federal Excise tax $ 500,000 Black Lung $ 800,000 AML $ 400,000 Royalty $ 1,500,000	$ 5,400,000
991	$ 19,370,000 Includes Reimbursement for Black Lung $ 840,000 AML $ 400,000	$ 9,190,000	$ 18,110,000 Excludes Reimbursement for Black Lung $ 840,000 AML $ 400,000	$ 9,070,000		

ndustry computations as adjusted to MMS production projections.

August 27, 198

EXHIBIT B

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION

MONTANA

1) The MMS analysis of the impact of the Industry Proposal was released without reference to the actual price and production assumptions, thus making it extremely difficult to evaluate the validity of the results. However, certain things are known about how MMS proceeded. MMS assumed prices would not change in the 1987-1991 time frame. It also used lessee reported data by lease for the first half of calendar year 1987 (multiplied by 2) as the base year. Since MMS elected not to divulge actual price and production assumptions, and everyone seems to agree that prices are not generally increasing, MMS price assumptions should not depart substantially from 1986 levels as found in Exhibit A and The 1986 Report on Receipts from Federal and Indian Lands, published by the U.S. Dept. of Interior.

   If MMS used something close to the $12.61 actual 1986 price as representative of the 1990 price per ton (Exhibit A) in calculating total royalty before deductions of $30.88 mm (Exhibit B), annual production would be 19.591 mm tons in 1990.

   ($30.88 mm ÷ 12.5% = $247.043 mm ÷ $12.61 = 19.591 mm tons)

   We believe the cut in severance tax, coupled with logistical advantages relative to North Central states' markets will offset production losses caused by Western competitive pressures. The result will likely be the maintenance of production at or near the 1986 level -- in the 24 mm ton per year range.

2) MMS ignored significant ¢ per ton federal production in its projection of total 1990 federal royalty receipts.

3) Using MMS price and tonnage assumptions, Black Lung Excise Tax would be $10.412 mm, not $9.040.

   $247.043 ÷ 104.4% = $236.631 mm x 4.4% = $10.412 mm

4) Apparently MMS used a different production level to compute Abandoned Mine Land Fee than it did to compute royalty.

   $.83 mm ÷ 12.5% = $6.64 mm ÷ $.35 = 18.971 mm tons

---

5) The impact of eliminating the compounding of royalty upon itself has been so severely overstated that the entire MMS Montana analysis is rendered essentially useless. According to the MMS calculations (Exhibit B), the impact of eliminating federal royalty will be \$3.8 mm based on royalty of \$30.4 mm, which is 172% of the 17.68 federal royalty calculated by MMS.

   Logic suggests that the royalty deduction will equal the actual royalty amount.

6) Post marketable condition handling value (Processing Allowance) is overstated at \$12 mm in value and \$1.5 mm in royalty impact. Using MMS calculated gross receipts, and assuming that 4% is a reasonable estimate of the portion of the total price that is attributable to activity occurring after marketable condition has been achieved, the resulting impact would be \$1.235 mm, not \$1.5 mm.

   (\$247.043 mm x 4% = \$9.882 mm x 12.5% = \$1 235 mm)

7) MMS indicates in Exhibit B that another excise tax applies to coal (in addition to Black Lung Excise Tax), and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

9/020

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
MONTANA
(Amounts in millions except per ton prices and royalty rate)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$ 12.610			$ 9.000		
B)	Projected Ad Valorem Production (Tons)	19.591			22.500*		
	Projected Ad Valorem Gr. Receipts (AxB)	$247.043			$202.500		
C)	Projected Ad Valorem Royalty @ 12.5%		$30.880	**$15.440**		$25.313	**$12.656**
	Projected $/Ton Royalty:						
	Tons		-0-	**-0-**	1.500*		
	Rate		-0-	**-0-**	.240		
	Royalty		-0-	**-0-**		.360	**.180**
	Total Projected Royalty		$30.880	**$15.440**		$25.673	**$12.836**
D)	Black Lung Excise Tax	(9.040)	(1.130)	**(.565)**	(8.534)	(1.067)	**(.533)**
E)	Abandoned Mine Land Fee	(6.640)	(.830)	**(.415)**	(7.875)	(.984)	**(.492)**
	Projected Royalty - MMS Proposal	$231.363	$28.920	**$14.460**	$186.091	$23.622	**$11.811**
F)	Royalty on Itself	(30.400)	(3.800)	**(1.900)**	(15.727)	(1.966)	**(.983)**
G)	Post Mkt. Cond. Handling Value	(12.000)	(1.500)	**(.750)**	(8.100)	(1.013)	**(.507)**
H)	State and Local Sev./Prod. Tax	(44.800)	(5.600)	**(2.800)**	(36.450)	(4.556)	**(2.278)**
I)	Other	(2.720)	(.340)	**(.170)**	-0-	-0-	**-0-**
	Projected Royalty - Industry Proposal	$141.443	$17.680	**$ 8.840**	$125.814	$16.087	**$ 8.043**
	Difference Between MMS & Ind. Proposal		$11.240	**$ 5.620**		$ 7.535	**$ 3.768**

NOTE -- Sources, assumptions and calculations explained on following page.

*Total projected 1990 tons = 24 mm (22.5 mm tons Ad Valorem and 1.5 mm tons $/ton)

9/030

PROJECTED 1990 FEDERAL ROYALTY COMPARISON - MONTANA

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Price will drop from the 1986 level of $12.61 per ton to $9.00 per ton by 1990 for the following reasons:

1) The soft market will continue to produce spot prices drastically below total average prices well beyond 1990.

2) A significant portion of existing coal supply agreements will be replaced or renegotiated in the 1987-1989 period. The result will be a substantial lowering of the total weighted average price.

3) Montana's severance tax reduction will cause long term contract price de-escalation.

B) Production from federal leases in Montana will remain relatively flat -- in the 24 mm ton/yr. range through 1990. Major factors that may impact production levels negatively are:

1) The Pacific Corp/Utah Power merger will reduce demand for Montana Power's off-system power sales.

2) Higher production costs may cause some shift to Wyoming Powder River Basin.

Factors that may impact production levels positively are:

1) The severance tax reduction should help Montana maintain market share by offsetting losses discussed above.

2) Additional spot sale opportunity should develop in Wisconsin, Minnesota and Michigan, with Montana being in a favorable position, transportation-wise, to fill the need.

C) All 1990 projected Montana federal coal production is assumed to be from surface mines. There will still be one lease paying royalty on a ¢ per ton basis in 1990 at an estimated rate of 1.5 mm tons annually. This lease will undergo readjustment in 1991, and will bear ad valorem royalty thereafter.

D) Black Lung Excise Tax Calculation:

$202.5 mm ÷ 104.4% = $193.996 mm x 4.4% = $8.534 mm x 12.5% - $1.067 mm

E) Abandoned Mine Land Fee Calculation:

22.5 mm tons x $.35 = $7.875 mm x 12.5% = $.984 mm

F) Royalty on Itself Calculation:

$16.087 mm - $.360 = $15.727 mm x 12.5% = $1.966 mm

G) Post Marketable Condition Handling Value Calculation:

$202.5 mm x 4% = $8.1 mm x 12.5% = $1.013 mm

H) State and Local Severance Tax Calculation:

$202.5 mm x 18%* = $36.45 mm x 12.5% = $4.556 mm
*Assumed:

- State severance tax of 22.5% of Taxable Value in 1990 (Reduced from 30% in 1987)
- Taxable Value (Net of Production Taxes and government royalties) will be approximately 57.8% of Gross Receipts
- Average Gross Proceeds Tax rate of 4.6% of Taxable Value
- Resource Indemnity Trust Tax rate of .4%
- 22.5% x 57.8% = 13% + 4.6% + .4% = 18%

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1986 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deduction
Colorado	$18.92 (Deep & Surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.29 21.46%/17.3
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.065 4.48%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

EXHIBIT A

[illegible]
STATE OF MONTANA

CAST AR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
187	$ 29,110,000 Includes Reimbursement for Black Lung $1,060,000 AML $ 780,000	$ 14,555,000				
9[illegible]	$ 29,680,000 Includes Reimbursement for Black Lung $1,080,000 AML $ 800,000	$ 14,840,000	$ 27,800,000 Excludes Reimbursement for Black Lung $1,080,000 AML $ 800,000	$ 13,900,000		
989	$ 30,270,000 Includes Reimbursement for Black Lung $1,100,000 AML $ 810,000	$ 15,135,000	$ 28,350,000 Excludes Reimbursement for Black Lung $1,100,000 AML $ 810,000	$ 14,175,000	$ 17,680,000 Excludes Reimbursement for Severance/prod. tax $5,600,000 Processing All. $1,500,000 Federal Excise tax $ 340,000 Black Lung $1,130,000 AML $ 830,000 Royalty $3,800,000	$ 8,840,000*
1990	$ 30,880,000 Includes Reimbursement for Black Lung $1,130,000 AML $ 830,000	$ 15,440,000	$ 28,880,000 Excludes Reimbursement for Black Lung $1,130,000 AML $ 830,000	$ 14,440,000		
1991	$ 32,180,000 Includes Reimbursement for Black Lung $1,190,000 AML $ 880,000	$ 16,090,000	$ 30,110,000 Excludes Reimbursement for Black Lung $1,190,000 AML $ 880,000	$ 15,055,000		

August 27, 1987

*ndustry computations as adjusted to MMS production projections.

$\frac{830,000}{12.5\%}$ = 6,640,000 ÷ .35 = 18,971,429 tons / [illegible]

$\frac{30,880,000}{12.5\%}$ = 247,040,000 ÷ 12.61 = 19,590,801 / [illegible]

619,372 Tons diff

EXHIBIT B

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION

NEW MEXICO

1) The MMS analysis of the impact of the Industry Proposal was released without reference to the actual price and production assumptions, thus making it extremely difficult to evaluate the validity of the results. However, certain things are known about how MMS proceeded. MMS assumed prices would not change in the 1987-1991 time frame. It also used lessee reported data by lease for the first half of calendar year 1987 (multiplied by 2) as the base year. Since MMS elected not to divulge actual price and production assumptions, and everyone seems to agree that prices are not generally increasing, MMS price assumptions should not depart substantially from 1986 levels as found in Exhibit A and The 1986 Report on Receipts from Federal and Indian Lands, published by the U.S. Dept. of Interior.

   If MMS used something close to the $23.76 actual 1986 price as representative of the 1990 per ton price (Exhibit A) in calculating total royalty revenue to be $91.6 million (Exhibit C), total 1990 tons will be approximately 3.855 million.

   ($11.450 mm ÷ 12.5% = $91.6 mm ÷ $23.76 = 3.855 mm tons).

   If this assumption is reasonable, there will be a substantial drop in production of federal coal from New Mexico mines in the 1986 to 1990 period from 4.6 million tons to 3.855 million tons (16.2%). We believe this assumption is unrealistic. Independent market research suggests that stable contractual relationships coupled with the continuing soft market and increased competitive pressures will hold both price and production at or slightly less than 1985/86 levels, assuming a reasonable federal royalty policy.

2) MMS apparently used a different production level to calculate Black Lung Excise Tax than total royalty revenue.

   Royalty Tons = $11.450 mm ÷ 12.5% = $91.6 mm ÷ $23.76 = 3.855 mm tons

   Tax Tons = $.240 mm ÷ 12.5% = $1.92 mm ÷ $.55 = 3.491 mm tons

3) In keeping with the inconsistency demonstrated in (2) above, MMS used yet another production level to calculate the impact of deducting Abandoned Mine Land Fees.

   AMLF Tons = $.160 mm ÷ 12.5% = $1.280 mm ÷ $.35 = 3.657 mm tons

Problems with MMS 1990 Federal Coal Royalty Projection - New Mexico
Page 2.

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4) The estimate of the impact of eliminating federal royalty compounding conflicts with the MMS calculation of royalty under the Industry Proposal as follows:

MMS Calculated Royalty Per Industry Proposal	$8.45 mm tons
MMS Calculated Royalty Deduction $1.2 mm ÷ 12.5%	9.60 mm tons

Justification for the assertion that the deduction of federal royalty will exceed total federal royalty is not apparent.

5) A realistic estimate of the impact of the so-called "processing allowance" is 4% of total average selling price, which would result in impact of $.458 million using MMS price and production assumptions.

($91.6 mm x 4% = $3.664 mm x 12.5% = $.458 mm).

The methodology used by MMS to calculate the $.500 impact of this deduction is not readily apparent.

6) MMS used an incomplete tax rate to calculate impact of severance tax deduction ($1.065/ton per Exhibit A instead of $1.595/ton per Exhibit D). The effect of using the wrong rate is more than offset by the use of yet a different production level than that used for total royalty, Black Lung Excise Tax and Abandoned Mine Land Fee.

Severance Tax Tons = $.7 mm ÷ 12.5% = $5.6 mm ÷ $1.065 = 5.258 mm tons

7) MMS indicates on Exhibit C that another excise tax applies to coal (in addition to the Black Lung Excise Tax), and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
NEW MEXICO

(Amounts in millions except per ton prices and royalty rate)

	Original MMS Projection			Revised Projection		
	Value	Royalty	State Share	Value	Royalty	State Share
A) Projected Selling Price/Ton	$23.760			$ 22.670		
B) Projected Ad Valorem Production (Tons)	3.855			4 500		
Projected Ad Valorem Gr. Receipts (AxB)	$91.600			$102 15		
C) Projected Ad Valorem Royalty @ 12.5%		$11.450	**$ 5.725**		$12.751	**$ 6.376**
D) Black Lung Excise Tax	(1.920)	(.240)	**(.120)**	(2.475)	(.309)	**(.155)**
E) Abandoned Mine Land Fee	(1.280)	(.160)	**(.080)**	(1.575)	(.197)	**(.098)**
Projected Royalty - MMS Proposal	$88.400	$11.050	**$ 5.525**	$ 97.965	$12.245	**$ 6.123**
F) Royalty on Itself	(9.600)	(1.200)	**(.600)**	(9.634)	(1.204)	**(.602)**
G) Post Mkt. Cond. Handling Value	(4.000)	(.500)	**(.250)**	(4.081)	(.510)	**(.255)**
H) State and Local Sev./Prod. Tax	(5.600)	(.700)	**(.350)**	(7.178)	(.897)	**(.449)**
I) Other	(1.600)	(.200)	**(.100)**	-0-	-0-	**-0-**
Projected Royalty - Industry Proposal	$67.600	$ 8.450	**$ 4.225**	$ 77.072	$ 9.634	**$ 4.817**
Difference Between MMS & Ind. Proposal		$ 2.600	**$ 1.300**		$ 2.611	**$ 1.306**

NOTE -- Sources, assumptions and calculations explained on following page.

9/003-2

PROJECTED 1990 FEDERAL ROYALTY CALCULATIONS - NEW MEXICO

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Source - New Mexico Dept. of Energy and Minerals Coal Industry Overview, July 14, 1987, pg. 2, Item G (Exhibit B). Assumed 1986 statewide price applicable to federal coal and will remain relatively flat through 1990.

B) Source - New Mexico 1985 federal production of 4.6 mm tons (Exhibit B, pg. 1), reduces slightly to 4.5 in 1990. Assumed relatively constant production level in spite of depressed market due to long term commitments discussed in Exhibit B.

C) Assumed all 1990 New Mexico federal coal production will be "surface", subject to Ad Valorem royalty @ 12.5%.

D) 4.5 mm tons @ $.55 = $2.475 x 12.5% = $.309.

E) 4.5 mm tons @ .35 = $1.575 x 12.5% = $.197.

F) $9.634 total royalty per industry proposal @ 12.5% = $1.204.

G) Assumed 4% of price attributable to post marketable condition handling ($102.015 @ 4% = $4.08 @ 12.5% = $.510)
Assumed MMS "washing allowance" proposal would yield no significant deduction.

H) Rate from Exhibit D applied to 4.5 mm tons
(4.5 mm tons x $1.595 = $7.178 x 12.5% = .897)

I) There is no other excise tax applied to coal. Therefore, there is no deduction.

MMS IMPACT ANALYSIS

September 23, 1987

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS IN SIX WESTERN STATES (Calendar Year 1986 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deduction
Colorado	$18.92 [Deep & surface not separated]	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.29* 21.46%/17.3
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.065 4.48%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

EXHIBIT A

STATE OF NEW MEXICO
ENERGY and MINERALS DEPARTMENT
525 Camino de los Marquez
Santa Fe, New Mexico
87501

GARREY CARRUTHERS
GOVERNOR

OVERVIEW:
THE NEW MEXICO COAL INDUSTRY

Presented to the Legislative Energy,
Natural Resources and Extractive Industries Committee

By the Energy, Minerals, and Natural Resources Department

July 14, 1987

I. New Mexico coal reserves, production and prices

A. Recoverable coal reserves in New Mexico are estimated at 4.7 billion tons, or 216 times the current annual production rate.

B. About 96% of New Mexico's total coal resources are located in the San Juan Basin. About 90% of New Mexico's current coal production occurs in the San Juan Basin; the remainder is mined from the Raton Basin.

C. A 74% growth in coal production from 1978 to 1984 has been followed by a leveling off at about 21.5 million tons per year and a slight decline in 1986. Production in 1986 was 21.3 million tons, down 1.4% from 1985.

D. Sales of New Mexico coal in 1986 totaled 21.9 million tons in 1986, meaning that stockpiles at coal mines were depleted by about 300,000 tons during the year. Stockpiling at mines and power plants is likely to increase in 1987 in anticipation of a possible strike in early 1988.

E. About 4.6 million tons of coal, 21% of the total production within the state, were mined on federal lands in 1985. About 8.0 million tons, or 37% of the total production, occurred on land leased by the Navajo Nation.

F. About 62% of the coal sold in New Mexico is currently consumed within the state, nearly all at three coal-burning power plants. Most of the coal shipped out of state travels to power plants in Arizona and, to a much lesser extent, to Texas.

EXHIBIT B

G. The average price paid for New Mexico coal in 1986 was $22.67 per ton, which represented a decline of 4.1% over average prices paid in 1985.

H. Coal was a $490 million business in New Mexico in 1986 measured by the gross income from coal sales.

I. The coal industry employed about 1,900 miners in 1986. Industry employment peaked at 2,090 workers in 1981 only to fall to 1,646 in 1983. More jobs have been created in recent years due to the opening of several new mines in the state.

II. National and world-wide comparisons

A. Total recoverable coal reserves in the United States are estimated at 482.9 billion tons. New Mexico coal constitutes 1.0% of domestic recoverable reserves; the state ranks 16th among the United States in terms of total coal reserves.

B. World-wide recoverable coal reserves are estimated to be 1.7 trillion tons, of which about 30% is located in the United States. Ten countries control more than 90% of the earth's coal, with the United States ranking first in terms of total coal reserves followed by Russia and China.

C. New Mexico coal production grew by 1.8% in 1985, while national output dropped 1.1%. National production declined by 0.2% in 1986 and New Mexico production fell by 1.4%. New Mexico mines supplied 2.5% of the nation's coal production in 1986.

D. World coal production in 1985 was 4,790 million tons, of which the United States contributed 18.6% and New Mexico accounted for 0.4%. The United States ranked second behind China in terms of total coal production in 1985; Russia, East Germany, Poland, and West Germany ranked third through sixth.

E. The average price for New Mexico coal in 1985 was slightly less than the national average price, continuing a long-term pattern. Compared with other major western coal producers, New Mexico coal is cheaper to buy than Colorado or Utah coal, but more expensive than Wyoming or Texas coal.

F. Other western coal producers, principally in Wyoming, Texas, Colorado, and Utah, are the major competitors of New Mexico in the national coal market. New Mexico currently does not experience major competition from foreign coal producers. New and proposed coal mines in Columbia, South America, however, could pose competitive threats in New Mexico's coal markets in the near future.

EXHIBIT B

III. Production costs and tax income

A. Worker productivity in New Mexico, measured by tons of coal mined per worker, is higher than in Colorado or Utah, much less than in Wyoming, and somewhat below the rate in Texas. Average annual wages paid to full-time coal miners in New Mexico were $41,104 in 1986.

B. The worker's compensation rate for surface miners in New Mexico is currently about $6.01 per hundred dollars of wages, which is about average among western states. The rate for underground mining in New Mexico, about $10.83 per hundred dollars in wages, is significantly higher than the $6 to $7 rate paid in Utah and Colorado, the leading underground mining states in the West.

C. Commercial rates for electricity sold in New Mexico are higher than average both for the United States as a whole and for the Rocky Mountain Region. The average New Mexico rate of 7.84 cents/kilowatt-hour is 9% above the national rate and 24% above the average rate in the region. About 93% of New Mexico's coal production is burned in electrical generating stations.

D. New Mexico's coal severance tax income is about $1.00 per ton, for a total annual income in recent years of about $21 million. A resource excise tax and a conservation tax is also collected on coal production. In 1986, direct state coal tax payments totalled $26.6 million. The state tax rate in New Mexico is currently about 5% of the sale price of coal. This rate is higher than the rate in Colorado, but lower than the rate in Wyoming. Neither Texas nor Utah apply severance taxes to coal.

E. New Mexico also receives about $1.25 per ton of federal coal mined within the state, for a total of about $5.5 million ~~tons~~ per year currently.

IV. Coal mines and markets

A. The are currently eight major active coal mines in New Mexico as follows:

- o Navajo - Utah International, Inc.
- o San Juan - San Juan Coal Co.
- o La Plata - San Juan Coal Co.
- o Gateway - Sunbelt Mining Co.
- o De-Na-Zin - Sunbelt Mining Co.
- o McKinley - Pittsburg & Midway
- o Lee Ranch - Santa Fe Pacific Coal
- o York Canyon and Cimmarron - Kaiser

B. Over half of New Mexico's coal production supplies two "mine-mouth" power plants near Farmington for which there are no alternative fuel supplies. The San Juan, Navajo, LaPlata, De-Na-Zin and Gateway mines supply these power plants. The Lee Ranch mine supplies a third power plant in New Mexico, the Escalante Generating Station.

C. New Mexico is the sole supplier of every coal burning power plant in Arizona with the exception of the Navajo plant which is in essence a mine-mouth facility. The Lee Ranch, McKinley, and Kaiser mines supply coal to Arizona utilities.

D. In recent years, the Kaiser mines near Raton have begun to to capture industrial and utility coal contracts in Texas, the nation's largest coal market.

E. The LaPlata, Lee Ranch and Cimmarron mines, each equipped with state-of-the-art technology, have opened in New Mexico in the last three years. Two other mines are in the development stage, the Dineh and the Fence Lake projects.

V. The mid and long term economic outlook

A. Maintenance of current production and markets is reasonably secure because of large mine-mouth consumption and dominance in the Arizona utility market.

B. Several mines in New Mexico are in an excellent position to compete for new contracts as the coal market improves.

C. The Dineh Power Project could provide major new markets for New Mexico coal within the next decade.

D. Emerging technologies and tighter environmental protection requirements could enhance the marketability of New Mexico coal.

VI. Current issues

A. Progress of the Dineh Service Company and other aspects of the Dineh Power Project including the Navajo land selection.

B. The fate of federal legislation and regulation-setting processes dealing with the following issues:

- Reform of the Staggers Act affecting rail transportation rates
- Enactment of a national acid rain control program
- The scope of the National Clean Coal Technology Program
- Promotion of coal slurry pipeline transportation

C. The future of Kaiser Coal Company.

D. Changes in federal coal land management policies and programs. — Royalty Value!!

EXHIBIT B

E. Development of new transportation systems within the state.

EXHIBIT B

MAJOR NEW MEXICO COAL FIELDS

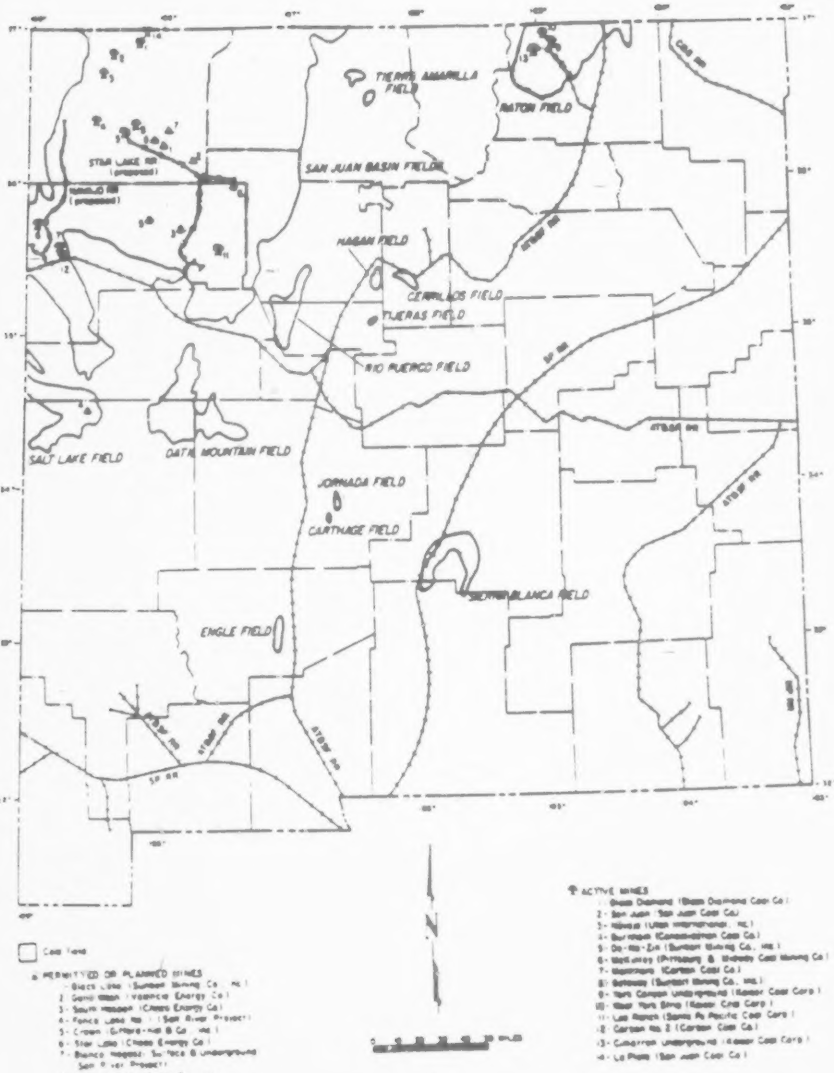
TIERRA AMARILLA FIELD
RATON FIELD
SAN JUAN BASIN FIELD
STAR LAKE RR (proposed)
(proposed)
HAGAN FIELD
CERRILLOS FIELD
TIJERAS FIELD
RIO PUERCO FIELD
SALT LAKE FIELD
DATIL MOUNTAIN FIELD
JORNADA FIELD
CARTHAGE FIELD
SIERRA BLANCA FIELD
ENGLE FIELD
AT&SF RR
SP RR
C&S RR
N
Coal field
PERMITTED OR PLANNED MINES
1- Black Lake (Sunbelt Mining Co., Inc.)
2- Gallo Wash (Valencia Energy Co.)
3- South Hospah (Chaco Energy Co.)
4- Fence Lake No. 1 (Salt River Project)
5- Crown (Gifford-Hill & Co., Inc.)
6- Star Lake (Chaco Energy Co.)
7- Blanco Nageezi Surface & Underground (Salt River Project)
8- Bisti (Sunbelt Mining Co., Inc.)
ACTIVE MINES
1- Black Diamond (Black Diamond Coal Co.)
2- San Juan (San Juan Coal Co.)
3- Navajo (Utah International, Inc.)
4- Burnham (Consolidation Coal Co.)
5- De-Na-Zin (Sunbelt Mining Co., Inc.)
6- McKinley (Pittsburg & Midway Coal Mining Co.)
7- Mentmore (Carbon Coal Co.)
8- Gateway (Sunbelt Mining Co., Inc.)
9- York Canyon Underground (Kaiser Coal Corp.)
10- West York Strip (Kaiser Coal Corp.)
11- Lee Ranch (Santa Fe Pacific Coal Corp.)
12- Carbon No. 2 (Carbon Coal Co.)
13- Cimarron Underground (Kaiser Coal Corp.)
14- La Plata (San Juan Coal Co.)

FIGURE 6—MAP OF THE MAJOR COAL FIELDS IN NM

EXHIBIT B

HISTORICAL NEW MEXICO COAL PRODUCTION

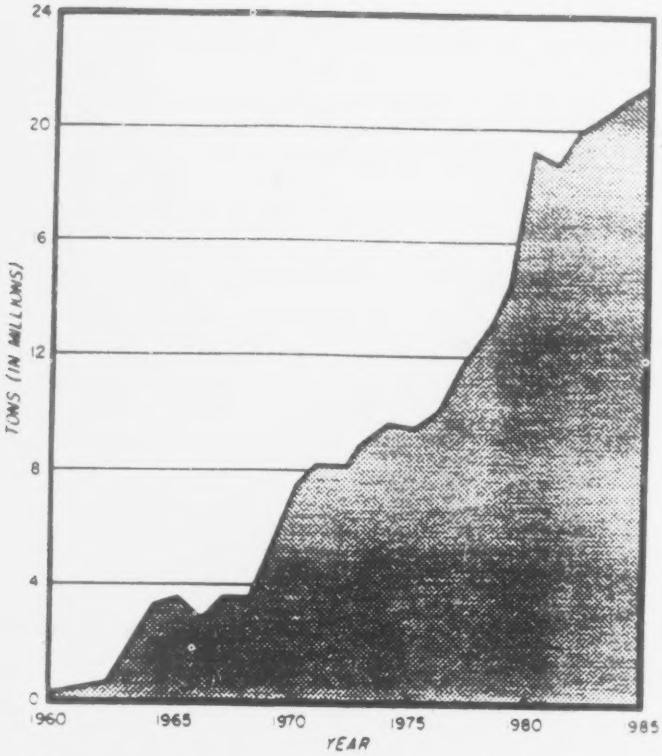

FIGURE 7—Coal production in New Mexico, 1960 through 1985 (data from the New Mexico Energy and Minerals Department.

EXHIBIT B

AVERAGE COAL PRICES

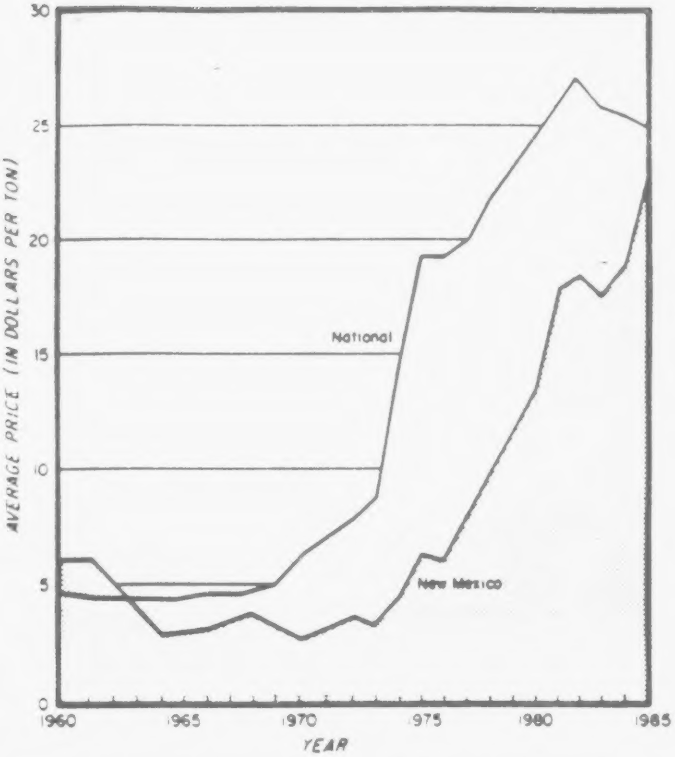

FIGURE 8—AVERAGE PRICES PAID FOR COAL PRODUCED IN NEW MEXICO AND THE UNITED STATES, 1960 THROUGH 1985 (data from the New Mexico Energy and Minerals Department, Bureau of Mines Inspection; U.S. Department of Energy, Energy Information Administration)

EXHIBIT 8

COAL SEVERANCE TAX COLLECTIONS

TABLE 45—Direct tax revenues from coal production in New Mexico, 1976 through 1985. Conservation tax collections are made in February through January of each year (data from New Mexico Department of Taxation and Revenue).

Year	Severance tax	Resources excise tax	Conservation tax	Total taxes
1976	$ 278,753	$ 313,902	$104,183	$ 696,838
1977	2,337,148	730,445	170,146	3,237,739
1978	4,791,920	991,413	239,788	6,023,121
1979	6,165,768	1,535,483	383,426	8,084,677
1980	9,925,782	1,982,206	494,357	12,402,345
1981	16,651,014	2,635,889	687,973	19,974,876
1982	17,452,689	2,707,027	633,013	20,792,729
1983	18,212,986	2,567,954	528,058	21,308,998
1984	20,655,675	2,991,216	693,777	24,340,668
1985	21,759,215	3,627,055	922,621	26,308,891

MARKETS FOR NEW MEXICO COAL

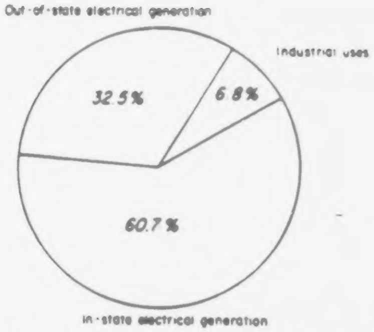

FIGURE 9—Consumption of New Mexico coal in 1985 by end use (data from the New Mexico Energy and Minerals Department, National Coal Association).

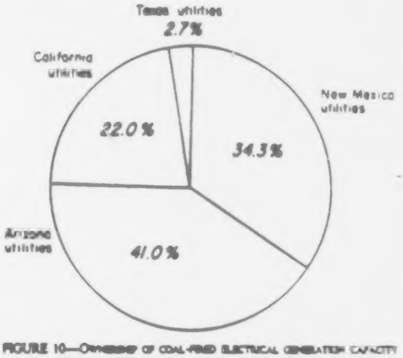

FIGURE 10—Ownership of coal-fired electrical generation capacity in New Mexico, 1985 (data from the New Mexico Energy and Minerals Department; U.S. Department of Energy, Energy Information Administration).

EXHIBIT B

Five Bills in Congress on Acid Rain Controls

Bill #	S 300	S 321	S 95	S 316	HR 4567 (99th Cong.)
Major Sponsor	Robert Stafford (R-VT)	George Mitchell (D-ME)	John Kerry (D-MA)	William Proxmire (D-WI)	Henry Waxman (D-CA)
States Affected	50 states	50 states	48 contiguous states	31 states east of or bordering on Mississippi R	50 states
Estimated Sulfur Dioxide Reduction Goals Compared to 1980 Emissions	appx. 10-12 million tons by 1995	12,000,000 tons by 1996	12,000,000 tons by 1995	10,000,000 tons by 1998	appx. 8-10 million tons by 1997
Estimated Nitrogen Dioxide Reduction Goals Compared to 1980 Emissions	Emissions keyed to Technology use in other countries: 1995 deadlines	4,000,000 tons by 1996	3,000,000 tons by 1995	3,000,000 tons by 1998	3,000,000 tons by 1997
Reduction Strategy	Emissions limits set for individual coal burning units based on age. Each unit must comply	Establishes statewide av. emissions limits. States develop own reduction strategy to meet target	Establishes statewide av. emissions limits. Some federal requirements for coal cleaning and adipic acid treatment	Establishes statewide av. emissions limits	Establishes statewide av. emissions limits
Method of Financing	Polluter Must Pay	Polluter Must Pay	48 state tax on electricity. From $.005/kwh-$.016/kwh. Applies to fossil fuel generation	Polluter Must Pay	National tax on electricity $.005/kwh excluding hydro and nuclear power
Interstate Emissions Trading Allowed	No	No	Yes	Yes	No
Smelter Control Deadline	No	Yes	No	Yes	Yes
International Cooperation	Yes	Yes	No	Yes	Yes
Automotive Emissions Reductions Required	Yes	Yes	Yes	Yes	Yes
Clean Coal Requirements	No	No	Yes	No	No

This table summarizes (as of May 1st) the major points of legislation contained in bills sponsored by four U.S. Senators and one Representative. Among the notable differences among the five bills: 1) regulations limited to 31 states east of the Mississippi or bordering thereon; (Proxmire Bill); 2) emissions limits set for individual coal-burning units based on age of each unit (Stafford Bill); 3) electricity tax on generating plants burning fossil fuels only (Kerry and Waxman bills). Also notable: all five bills call for reductions in emissions of pollutants from motor vehicles.

EXHIBIT B

MMS IMPACT ANALYSIS

ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF NEW MEXICO

FORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHAR
1987	$ 9,810,000 Includes Reimbursement for Black Lung $ 210,000 AML $ 130,000	$ 4,905,000				
1988	$ 11,000,000 Includes Reimbursement for Black Lung $ 230,000 AML $ 150,000	$ 5,500,000	$ 10,620,000 Excludes Reimbursement for Black Lung $ 230,000 AML $ 150,000	$ 5,310,000		
1989	$ 11,230,000 Includes Reimbursement for Black Lung $ 240,000 AML $ 150,000	$ 5,615,000	$ 10,830,000 Excludes Reimbursement for Black Lung $ 240,000 AML $ 150,000	$ 5,415,000	$ 8,450,000 Excludes Reimbursement for Severance/prod. tax $ 700,000 Processing All. $ 500,000 Federal Excise tax $ 200,000 Black Lung $ 240,000 AML $ 160,000 Royalty $1,200,000 [illegible]	$ 4,225,0
1990	$ 11,450,000 Includes Reimbursement for Black Lung $ 240,000 AML $ 160,000	$ 5,725,000	$ 11,050,000 Excludes Reimbursement for Black Lung $ 240,000 AML $ 160,000	$ 5,525,000		
1991	$ 11,670,000 Includes Reimbursement for Black Lung $ 250,000 AML $ 160,000	$ 5,835,000	$ 11,270,000 Excludes Reimbursement for Black Lung $ 250,000 AML $ 160,000	$ 5,635,000		

*Industry computations as adjusted to MMS production projections.

August 27,

EXHIBIT C

PROJECTED 1990 SEVERANCE TAX PER TON
NEW MEXICO

	1987 Rate	Estimated Adjustment to 1990	Projected 1990 Rate
Resource Excise Tax	.75%	--	$ .75
Conservation Tax	.19%	--	.19
Production Tax	1.20%	--	1.20
Severance Tax	$1.061/tn	periodically indexed	1.110

Projected 1990 Tax/Ton:			
Resource Excise Tax	.75% of $22.67	=	$ .170
Conservation Tax	.19% of $22.67	=	.043
Production Tax	1.20% of $22.67	=	.272
Severance Tax			1.110
Total Projected Tax Per Ton			$1.595

EXHIBIT D

9/004-2

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION
NORTH DAKOTA

1) The MMS analysis of the impact of the Industry Proposal was released without reference to the actual price and production assumptions, thus making it extremely difficult to evaluate the validity of the results. However, certain things are known about how MMS proceeded. MMS assumed prices would not change in the 1987-1991 time frame. It also used lessee reported data by lease for the first half of calendar year 1987 (multiplied by 2) as the base year. Since MMS elected not to divulge actual price and production assumptions, and everyone seems to agree that prices are not increasing, MMS price assumptions should not depart substantially from 1986 levels as found in Exhibit A and The 1986 Report on Receipts from Federal and Indian Lands, published by the U.S. Dept. of Interior.

   If MMS used something close to the $11.34 actual 1986 price as representative of the 1990 price per ton (Exhibit A) in calculating total royalty revenue before deductions of $7.78 mm (Exhibit B), projected annual tonnage would be 5.489 mm tons.

   ($7.78 mm ÷ 12.5% = $62.24 mm ÷ $11.34 = 5.489 mm tons)

   We believe the price assumption is too high and the production level too low. Inter-fuel competition and continuing soft market conditions will depress the price to approximately $9.50 per ton by 1990.

2) Assuming the Great Plains Gasification Project is operating at full capacity in 1990, total production should be approximately 9 mm tons. If the project is shut down (as some suggest), production will drop to 4 mm tons per year.

3) MMS apparently used a different production base to compute Abandoned Mine Land Fees than it did for total royalty.

   AMLF = $.08 mm ÷ 12.5% = $.64 mm ÷ $.10 = 6.4 mm tons*
   *This does not agree with (1) above

4) The impact of deducting the royalty to prevent compounding is incredibly overstated at 487% of MMS's own calculation.

MMS Computed Total Federal Royalty	$ 3.78 mm	(Exhibit B)
MMS Computed Royalty Deduction	$18.40 mm	(Attached Schedule)

   This distortion alone renders the MMS analysis results useless.

Problems with MMS 1990 Federal Coal Royalty Projection - North Dakota
Page 2.

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5) MMS indicated that a "processing allowance" would generate $.3 impact when, in fact, all North Dakota federal production is mine mouth to plant, without processing. Under the Industry Proposal, there would be no post marketable condition handling adjustment or "processing allowance".

6) State severance tax was apparently based on the $1.04 per ton rate found on Exhibit A. According to the North Dakota Department of Revenue, the tax rate applicable in 1990 (barring a law change) will be $.75 per ton.

7) MMS indicates in Exhibit B that another excise tax applies to coal (in addition to the Black Lung Excise Tax), and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

9/018

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
NORTH DAKOTA

(Amounts in millions except per ton prices and royalty rates)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$11.340			$ 9.500		
B)	Projected Ad Valorem Production (Tons)	5.489			9.000		
	Projected Ad Valorem Gr. Receipts (AxB)	$62.240			$85.500		
C)	Projected Ad Valorem Royalty @ 12.5%		$7.780	**$3.890**		$10.688	**$5.344**
D)	Black Lung Excise Tax	-0-	-0-	**-0-**	-0-	-0-	**-0-**
E)	Abandoned Mine Land Fee	(.640)	(.080)	**(.040)**	(.900)	(.113)	**(.056)**
	Projected Royalty - MMS Proposal	$16.600	$7.700	**$3.850**	$84.600	$10.575	**$5.288**
F)	Royalty on Itself	(18.400)	(2.300)	**(1.150)**	(8.650)	(1.081)	**(.541)**
G)	Post Mkt. Cond. Handling Value	(2.400)	(.300)	**(.150)**	-0-	-0-	**-0-**
H)	State and Local Sev./Prod. Tax	(5.600)	(.700)	**(.350)**	(6.750)	(.844)	**(.422)**
I)	Other	(4.960)	(.620)	**(.310)**	-0-	-0-	**-0-**
	Projected Royalty - Industry Proposal	$30.240	$3.780	**$1.890**	$69.200	$ 8.650	**$4.325**
	Difference Between MMS & Ind. Proposal		$3.920	**$1.960**		$ 1.925	**$ .963**

NOTE -- Sources, assumptions and calculations explained on following page.

PROJECTED 1990 FEDERAL ROYALTY COMPARISON - NORTH DAKOTA

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Price will drop from \$11.34 in 1986 to \$9.50 by 1990 due to continuing soft market conditions and strong inter-fuel competition from sources other than lignite generated power.

B) 1990 production should be approximately 9 mm tons, assuming the Great Plains Gasification Project is not terminated. Termination will result in a 5 mm ton per year drop in production.

C) All 1990 production assumed to be subject to 12.5% royalty rate.

D) Black Lung Exicse Tax does not apply to Lignite.

E) Abandoned Mine Land Fee Calculation:

9 mm tons x \$.10 = \$.9 mm x 12.5% = \$.113 mm

F) Royalty on Itself Calculation:

\$8.65 mm x 12.5% = \$1.081 mm

G) All North Dakota federal coal production is mine mouth and unprocessed. Therefore, there will be no deduction for post marketable condition handling value ("processing allowance").

H) State and Local Severance Tax Calculation:

9 mm tons x \$.75 = \$6.75 mm x 12.5% = \$.844

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1986 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deduction
Colorado	$18.92 (Deep & surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.29* 21.46%/17.39
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.065 4.48%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.51%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

EXHIBIT A

ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF NORTH DAKOTA

RECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
1987	$ 5,440,000 Includes Reimbursement for Black Lung $ - AML $ 60,000	$ 2,720,000				
1988	$ 7,480,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,740,000	$ 7,400,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,700,000		
1989	$ 7,630,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,815,000	$ 7,550,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,775,000		
1990	$ 7,780,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,890,000	$ 7,700,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,850,000	$ 3,780,000 Excludes Reimbursement for Severance/prod. tax $ 700,000 Processing All. $ 300,000 Federal Excise tax $ 620,000 Black Lung $ - AML $ 80,000 Royalty $2,300,000	$ 1,890,000
1991	$ 7,780,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,970,000	$ 7,860,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,430,000		

[1] Industry computations as adjusted to MMS production projections.

August 27, 198

EXHIBIT B

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION

UTAH

1) Average 1986 price of $28.45 per ton was used for 1990 (See Exhibit A) ignoring numerous factors that will depress prices in 1987, 1988 and 1989 (See detail following attached schedule).

2) Total 1990 royalty revenue before any deductions, using MMS assumptions, should have been $34.160 mm, not $34.140 as shown on MMS Utah Summary (Exhibit B).

3) Black Lung Excise Tax deduction erroneously calculated to be $1.24 mm per Exhibit B. Using MMS price and tonnage assumptions, the correct amount would have been 8% of (15 mm tns @ $1.10), or $1.32 mm.

4) Federal royalty deduction grossly exaggerated by MMS per Exhibit B at $4.6 mm on $57.5 mm royalty. MMS's own calculation of federal royalty under the Industry Proposal is $25.76 mm, which would yield a deduction of only $2.061 mm ($25.76 x 8%).

5) Post marketable handling value deduction is substantially overstated at $1.9 mm as compared to what would have been correct using MMS price and production assumptions.
(4% of $426.75 mm = $17.07 mm @ 8% = 1.366)

6) MMS indicates on Exhibit B that another excise tax applies to coal and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
UTAH

(Amounts in millions except per ton prices and royalty rates)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$ 28.450			$ 22.500		
B)	Projected Ad Valorem Production (Tons)	15.000			14.300		
	Projected Ad Valorem Gr. Receipts (AxB)	$426.750*			$321.750		
C)	Projected Ad Valorem Royalty @ 8%		$34.160*			$25.740	**$12.870**
D)	Projected $/Ton Royalty			**$17.080**			
E)	Black Lung Excise Tax	(15.500)	(1.240)	**(.620)**	(13.560)	(1.085)	**(.542)**
F)	Abandoned Mine Land Fee	(2.250)	(.180)	**(.090)**	(2.145)	(.171)	**(.086)**
	Projected Royalty - MMS Proposal	$409.250	$32.740	**$16.370**	$306.045	$24 484	**$12.242**
G)	Royalty on Itself	(57.500)	(4.600)	**(2.300)**	(21.717)	(1.737)	**(.869)**
H)	Post Mkt. Cond. Handling Value	(23.750)	(1.900)	**(.950)**	(12.870)	(1.030)	**(.515)**
I)	State and Local Sev./Prod. Tax	-0-	-0-	-0-	-0-	-0-	-0-
J)	Other	(6.000)	(.480)	**(.240)**	-0-	-0-	-0-
	Projected Royalty - Industry Proposal	$322.000	$25.760	**$12.880**	$271.458	$21.717	**$10.858**
	Difference Between MMS & Ind. Proposal		$ 6.980	**$ 3.490**		$ 2.767	**$ 1.384**

*MMS multiplication error ($28.45 x 15 x 8% = $34.140, not $34.160)

NOTE -- Sources, assumptions and calculations explained on following page.

9/005

PROJECTED 1990 FEDERAL ROYALTY COMPARISON - UTAH

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Price will drop from $28.45 in 1986 to $22.50 by 1990 for the following reasons:

- o Regulators are forcing utilities to reduce captive coal prices.
- o Spot prices are substantially below average contract price (currently $16-20) and expected to stay low.
- o A significant number of substantial coal supply agreements will be renegotiated by 1990, with prices moving nearer the spot price.
- o Low gas and oil prices will continue to reduce industrial coal prices.
- o Utility merger will increase competition and downward pressure on coal prices.

B) Production is expected to increase because additional coal fired generating capacity will become operational by 1990.

C) Projected Ad Valorem royalty based on 8% of gross receipts with no deductions (all deep coal).

D) All federal production in Utah will be on Ad Valorem basis by 1990.

E) Black Lung Excise is 4.4% of price less Black Lung Tax, maximum tax $1.10 for deep coal and $.55 for surface coal.

$$\frac{\$416.250\text{ mm}}{104.4\%} \times 4.4\% = \underline{\$28.095}\text{ mm}$$

F) AMLF is $.15/Ton for deep coal (18.5 mm tons @ $.15 = $2.775 mm)

G) Royalty per Industry Proposal is $28.095 mm @ 8% = $2.248 mm.

H) Approximately 4% of total average Utah coal value is added after defined point of first marketable condition per Industry Proposal.

I) Utah does not levy a severance tax on coal.

J) There is no other excise tax applied to coal. Therefore, there is no deduction.

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1986 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deductio
Colorado	$18.92 (Deep & surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.29 21.46%/17.3
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.065 4.48%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

A

EXHIBIT A

ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF U[illegible] Utah

ECAST EAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
1987	$ 31,210,000 Includes Reimbursement for Black Lung $1,150,000 AML $ 160,000	$ 15,605,000	—			
1988	$ 32,440,000 Includes Reimbursement for Black Lung $1,170,000 AML $ 170,000	$ 16,220,000	$ 31,100,000 Excludes Reimbursement for Black Lung $1,170,000 AML $ 170,000	$ 15,550,000		
1989	$ 33,480,000 Includes Reimbursement for Black Lung $1,210,000 AML $ 170,000	$ 16,740,000	$ 32,100,000 Excludes Reimbursement for Black Lung $1,210,000 AML $ 170,000	$ 16,050,000		
1990	$ 34,160,000 Includes Reimbursement for Black Lung $1,240,000 AML $ 180,000	$ 17,080,000	$ 32,740,000 Excludes Reimbursement for Black Lung $1,240,000 ✓ AML $ 180,000 ✓	$ 16,370,000	$ 25,760,000 Excludes Reimbursement for Severance/prod. tax $ - Processing All. $1,900,000 Federal Excise tax $ 480,000 Black Lung $1,240,000 AML $ 180,000 Royalty $4,600,000	$ 12,880,000*
1991	$ 34,840,000 Includes Reimbursement for Black Lung $1,260,000 AML $ 180,000	$ 17,420,000	$ 33,400,000 Excludes Reimbursement for Black Lung $1,260,000 AML $ 180,000	$ 16,700,000		

Industry computations as adjusted to MMS production projections.

August 27, 198

$\frac{180,000}{8\%}$ = 2,250,000 ÷ .15 = 15,000,000 tons

$\frac{34,160,000}{12\%}$ = [illegible] ÷ [illegible] = 15,003,787

EXHIBIT B

PROBLEMS WITH MMS 1990 FEDERAL COAL ROYALTY PROJECTION

WYOMING

1) The MMS analysis of the impact of the Industry Proposal was released without reference to the actual price and production assumptions, thus making it extremely difficult to evaluate the validity of the results. However, certain things are known about how MMS proceeded. MMS assumed prices would not change in the 1987-1991 time frame. It also used lessee reported data by lease for the first half of calendar year 1987 (multiplied by 2) as the base year. Since MMS elected not to divulge actual price and production assumptions, and everyone seems to agree that prices are not generally increasing, MMS price assumptions should not depart substantially from 1986 levels as found in Exhibit A and The 1986 Report on Receipts from Federal and Indian Lands, published by the U.S. Dept. of Interior.

   If MMS used something near the average 1986 price of $13.52 per ton as representative of 1990 price (See Exhibits A & B), the resulting impact is grossly overstated. The average price of Wyoming federal coal in 1986 was substantially less than $13.52 per ton. Analysis of publicly available information suggests the 1986 price was in the $9.50 to $10.00 range. This price is confirmed by published data from the Wyoming Department of Revenue. Using $9.67 as the 1986 price and taking into account a long term market oversupply, spot prices in the $3-4 range and the fact that several major long term coal supply agreements will be renegotiated in 1988-89, the average price will most likely drop to approximately $7.60 per ton by 1990.

2) If MMS used $13.52 as the 1990 per ton price (Exhibit A), and calculated total royalty revenue of $115.340 mm (Exhibit C), total tons could not be more than 68.249 million.

   ($115.340 ÷ 12.5% = 922.720 ÷ $13.52 = 68.249 tons)

   It appears that MMS ignored the large portion of Wyoming federal production that still bears a $.20/ton royalty, which severely distorts the revenue comparisons.

   Realistically, Wyoming federal coal production will increase slightly from the 1986 level of 111.408 million tons to approximately 115 million tons by 1990, due to slight market growth and relatively lower costs.

3) Using MMS price and production assumptions, Black Lung Excise Tax would be $37.537 million, not $35.840 million. MMS apparently used a different production level to calculate the tax than it did to calculate total royalty.

   Royalty Tons = $115.340 mm ÷ 12.5% = $922.72 mm ÷ $13.52 = 68.249 mm tons
   Tax Tons = $4.480 mm ÷ 12.5% = $35.84 mm ÷ $.55 = 65.164 mm tons

---

4) In keeping with the inconsistency demonstrated in (3), MMS used yet a different production level to calculate Abandoned Mine Land Fee, as follows:

   AMLF Tons = \$3.67 mm ÷ 12.5% = \$29.36 mm ÷ \$.35 = 83.886 mm tons

   An explanation of these inconsistencies is not readily apparent.

5) A realistic estimate of the impact of the so-called "processing allowance" is 4.5% of total average selling price for Wyoming production, which would result in royalty impact of \$5.19 million using MMS price and tonnage assumptions.

   (\$922.726 mm x 4.5% = \$41.523 mm x 12.5% = \$5.190 mm)

   The methodology used by MMS to calculate the \$6.1 million impact of this deduction is not readily apparent.

6) According to Exhibit A, MMS ascertained that Wyoming severance tax is \$1.42/ton or 10.5% of selling price. In fact, neither is the case. Total Wyoming state and local severance/production tax is approximately 15% of taxable value (8.5% state and 6.5% local). Taxable value equals selling price reduced by approximately 25% (for federal royalty, state royalty and post mine mouth value -- all of which are not taxable in Wyoming).

   It is interesting to note that if MMS used \$1.42 as the basis for severance tax (as shown in Exhibit A), total production would have been:

   \$15.5 million ÷ 12.5% = \$124 million ÷ 1.42 = 87.324 million tons

   This production level is again different from those apparently used for total royalty, Black Lung Excise Tax and Abandoned Mine Land Fee.

7) MMS indicates on Exhibit C that another excise tax applies to coal (in addition to Black Lung Excise Tax) and that the Industry Proposal is to deduct the tax. There is no such tax, nor is there a proposal to deduct it.

PROJECTED 1990 FEDERAL ROYALTY COMPARISON
WYOMING
(Amounts in millions except per ton prices and royalty rate)

		Original MMS Projection			Revised Projection		
		Value	Royalty	State Share	Value	Royalty	State Share
A)	Projected Selling Price/Ton	$ 13.520			$ 7.600		
B)	Projected Ad Valorem Production (Tons)	68.249			89.500**		
	Projected Ad Valorem Gr. Receipts (AxB)	$922.726			$680.200		
C)	Projected Ad Valorem Royalty @ 12.5%		$115.340	$57.580*		$85.025	$42.513
	Projected $/Ton Royalty:						
	Tons		-0-	-0-	25.500**		
	Rate		-0-	-0-	.200		
	Royalty		-0-	-0-		5.100	2.550
	Total Projected Royalty		$115.340	$57.580*		$90.125	$45.063
D)	Black Lung Excise Tax	(35.840)	(4.480)	(2.240)	(28.667)	(3.583)	(1.792)
E)	Abandoned Mine Land Fee	(29.360)	(3.670)	(1.835)	(31.325)	(3.916)	(1.958)
	Projected Royalty - MMS Proposal	$857.526	$107.190	$53.510*	$620.206	$82.626	$41.313
F)	Royalty on Itself	(92.000)	(11.500)	(5.750)	(57.008)	(7.126)	(3.563)
G)	Post Mkt. Cond. Handling Value	(48.800)	(6.100)	(3.050)	(30.609)	(3.826)	(1.913)
H)	State and Local Sev./Prod. Tax	(124.000)	(15.500)	(7.750)	(76.523)	(9.565)	(4.783)
I)	Other	(20.000	(2.550)	(1.275)	-0-	-0-	-0-
	Projected Royalty - Industry Proposal	$572.326	$ 71.540	$35.770	$456.068	$62.109	$31.054
	Difference Between MMS & Ind. Proposal		$ 35.770	$17.740		$20.517	$10.259

*These amounts are arithmetically incorrect.
The state share is 50% of the total which is $57.670 an $53.595 respectively.

**Total projected 1990 tons = 115 mm (89.5 mm tons Ad Valorem and 25.5 mm tons $/ton)

NOTE -- Sources, assumptions and calculations explained on following page.

9/029

PROJECTED 1990 FEDERAL ROYALTY COMPARISON - WYOMING

INDUSTRY SOURCES, ASSUMPTIONS AND CALCULATIONS

A) Price will drop from the 1986 range of $9.50-$10.00 per ton to $7.60 per ton by 1990 for the following reasons:

1) The soft market will continue to produce spot prices in the $3-$4 range.

2) Several major coal supply agreements serviced from Wyoming mines on federal leases will be replaced or renegotiated in the 1987-1989 period. The result will be a substantial price reduction that will depress the total weighted average price by approximately 22%.

B) Production will increase slightly from the 1986 level of 111,407,678 tons due to the relative competitive advantage of Powder River Basin production costs. The Wyoming increase will mainly displace higher cost production from federal leases in other states. Due to the relative price difference, total royalty collections for all federal coal will drop as a result of this shift. 1990 production levels could change significantly if utility purchasing practices are altered by government cost changes and other competitive pressures.

C) Total projected 1990 royalty will still include approximately 25.5 mm tons produced under ¢/ton leases that will not be subject to readjustment until 1991 and 1992. Ad Valorem royalty was calculated using the 12.5% surface rate because the small deep coal production that may occur in Wyoming in 1990 is not significant as compared to the total.

D) Black Lung Excise Tax Calculation:

$680.200 mm ÷ 104.4% = $651.533 mm x 4.4% = $28.667 mm x 12.5% = $3.583 mm

E) Abandoned Mine Land Fee Calculation:

89.5 tons @ $.35 = $31.325 mm @ 12.5% = $3.916 mm

F) Royalty on Itself Calculation:

$62.109 mm - $5.1 mm ¢/ton = $57.008 mm x 12.5% = $7.126 mm

G) Based on cost analysis for Wyoming severance tax purposes, post marketable condition handling value ("Processing Allowance") averages 4.5% of total price. Therefore, the impact of this adjustment is calculated as follows:

$680.2 mm x 4.5% = $30.609 mm x 12.5% = $3.826 mm

H) State and Local Severance Tax Calculation:

$680.2 mm - 25% = $510.15 mm x 15%* = $76.523 mm x 12.5% = $9.565 mm

*Statutory state rate 8.5%, approximate local rate 6.5%, rates apply to selling price less government royalties and post mine mouth value (deductions are approximately 25% of price).

CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1980 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deductio
Colorado	$18.92 (Deep & surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.29 21.46%/17.
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.069 4.50%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.

EXHIBIT A

- North Dakota: - 3.11%

- The 1986 tonnage figures were extracted from the *Federal Coal Management Report, Fiscal Year 1986*.

- The industry projected Federal Royalty Receipts for 1990 were calculated by multiplying price/ton times expected Federal production for 1990. Those products were then multiplied by the prevailing royalty rate to determine annual royalty receipts.
  - All production was assumed to occur from leases with ad valorem (percentage) royalty rates.
  - The following royalty rates were used: Colorado (surface), 12.5%; Colorado (underground), 8%; Montana, 12.5%; New Mexico, 12.5%; Wyoming, 12.5%; Utah, 8%; and North Dakota 12.5%.

- MMS noted computation errors in the industry submittal as follows: Colorado (surface) projected 1990 royalty receipts should be $19.176 million; Colorado (underground) projected 1990 royalty receipts should be $6.127; and Utah projected 1990 royalty receipts should be $31.280.

- Actual 1986 royalty receipts were extracted from the *Federal Coal Management Report, Fiscal Year 1986*. The 1986 royalty receipts shown for New Mexico were copied incorrectly. The correct New Mexico royalty receipts stated in the *Federal Coal Management Report, Fiscal Year 1986* is $15.402 million.

Methodology and Assumptions Used in MMS Royalty Impact Analysis

- Coal values were derived on a lease- and mine-specific basis using available royalty information reported to the Minerals Management Service (MMS) in the first half of Calendar Year 1987. Where actual lease-specific information was unavailable, MMS employed coal values from nearby leases. Knowledge of market conditions and professional judgment were also used to establish coal values in certain instances when other methods could not be used.

- The coal values determined for 1987 were used for years 1988-1991 without escalation. According to *Coal Week* (Vol. 13, No. 47, Nov. 24, 1986) "Coal prices will continue to remain flat for years . . . ."

- Calendar Year 1987 tonnage was determined by doubling actual reported tonnage for the first half of that year. Tonnage figures were compiled on a lease-by-lease basis.

- Tonnage estimates for year 1988-1991 were determined by increasing prior year tonnage by 2 percent. The 2 percent production increase per year is based on the following publications. The publication *Wyoming Geo-Notes No. 14* (April 1987) by the Geological Survey of Wyoming forecasts (p. 19) an average annual growth rate of 2 percent for Wyoming coal production through

ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF WYOMING

FORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHAR
1987	$ 71,880,000 Includes Reimbursement for Black Lung $2,430,000 AML $2,040,000	$ 35,960,000				
1988	$ 98,770,000 Includes Reimbursement for Black Lung $3,790,000 AML $3,090,000	$ 49,300,000	$ 91,890,000 Excludes Reimbursement for Black Lung $3,790,000 AML $3,090,000	$ 45,860,000		
1989	$104,760,000 Includes Reimbursement for Black Lung $4,020,000 AML $3,290,000	$ 52,290,000	$ 97,450,000 Excludes Reimbursement for Black Lung $4,020,000 AML $3,290,000	$ 48,640,000		
1990	$115,340,000 Includes Reimbursement for Black Lung $4,480,000 AML $3,670,000	$ 57,580,000	$107,190,000 Excludes Reimbursement for Black Lung $4,480,000 AML $3,670,000	$ 53,510,000	$ 71,540,000 Excludes Reimbursement for Severance/prod. tax $15,500,000 Processing All. $ 6,100,000 Federal Excise tax $ 2,550,000 Black Lung $ 4,480,000 AML $ 3,670,000 Royalty $11,500,000	$ 35,770,00
1991	$144,150,000 Includes Reimbursement for Black Lung $5,910,000 AML $4,800,000	$ 71,990,000	$133,440,000 Excludes Reimbursement for Black Lung $5,910,000 AML $4,800,000	$ 66,630,000		

¹Industry computations as adjusted to MMS production projections.

August 27, 19

[illegible] = 83,886 [illegible]

[illegible] = 68,249 [illegible]

EXHIBIT C

MMS COMPARATIVE ANALYSIS

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United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

SEP 23 1987

Note

To: Attendees at Meeting on Coal Product Value
Denver - September 28, 1987

The attached analysis of the royalty impact of the coal industry's proposal is tentative; it has not been reviewed in detail by Minerals Management Service top management or myself. With this caveat, I hope this material will be useful as you prepare for our meeting.

I look forward to seeing you on Monday.

J. Steven Griles

Identical information was sent to:

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State of Utah
Administrator Assistant
210 State Capitol
Salt Lake City, Utah 84114

Ms. Nancy Fruedenthal
State of Wyoming
c/o Governor's Office
State Capitol
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Mr. Ron Cattany
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Department of Natural Resources
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Natural Resource and
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Ms. Anita Lockwood
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Resource Department
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ROYALTY IMPACT ESTIMATE
OF
COAL INDUSTRY PROPOSAL

EXECUTIVE SUMMARY

The Minerals Management Service (MMS) estimates that there will be a decrease in total Federal coal royalty revenue receipts averaging about $13 million per annum for production from the six major Western coal producing States for the calendar year period 1988-1991 if its proposed coal valuation regulations were to be adopted (52 F.R. 1840, January 15, 1987). This would be an average annual reduction of about 6 percent from what could be expected under the current regulations.

The significant difference between MMS's current valuation regulations and its proposed valuation regulations published in the Federal Register is the exclusion in the proposed regulations of reimbursements to the Federal lessee by its purchaser of the Black Lung Excise Tax (Black Lung) and the Abandoned Mine Lands Reclamation Fee (AML).

Does not Agree with MMS numbers

In addition, MMS has analyzed a Federal coal royalty valuation proposal furnished by the coal industry. Using industry estimates, MMS concludes that there could be a decrease in total Federal coal royalty revenue receipts of about $80 million per annum for Calendar Year 1990 production from the six major Western coal producing States if the coal industry valuation proposal were to be adopted as regulation by the Department of the Interior (52 F.R. 29868, August 12, 1987). This would be an average annual reduction

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in royalty receipts of about 37 percent from what could be expected under MMS's current regulations and a 32 percent reduction from MMS's January 15, 1987, proposed regulations.

The major difference between the coal industry proposal and the MMS proposed regulations is the exclusion from value for royalty purpose of reimbursements to the Federal lessee by its purchaser of payments of royalties to the Federal Government and payments of severance/production taxes to the States where the coal is produced. Also excluded under the coal industry proposal as a "processing allowance" are all costs incurred after crushing and sizing of the coal to prepare the coal for market.

The State-by-State breakdown of estimated reduction in royalties from the MMS January 15, 1987, proposed regulations is as follows:

Estimated Reduction in Royalties, State Share

(Excludes Reimbursement for Black Lung and AML from Royalties)

State	1988	1989	1990	1991
Colorado	($ 560,000)	($ 590,000)	($ 600,000)	($ 620,000)
Montana	($ 940,000)	($ 955,000)	($ 980,000)	($1,035,000)
New Mexico	($ 190,000)	($ 195,000)	($ 200,000)	($ 205,000)

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			1990	
North Dakota	($ 40,000)	($ 40,000)	($ 40,000)	($ 40,000)
Utah	($ 670,000)	($ 690,000)	($ 710,000)	($ 720,000)
Wyoming	($3,440,000)	($3,655,000)	($4,075,000)	($5,355,000)

6.605 — [illegible] AMLF only

The State-by-State breakdown of estimated reductions in royalties from the coal industry August 12, 1987, proposed valuation procedure is as follows:

Estimated Reduction in Royalties, State Share

(Excludes Reimbursements for Black Lung, AML, State Severance/Production Taxes, Federal Royalty, and a "Processing Allowance" from Royalties)

State	1990
Colorado	($ 3,950,000)
Montana	($ 6,600,000)
New Mexico	($ 1,500,000)
North Dakota	($ 2,000,000)
Utah	($ 4,200,000)
Wyoming	($21,810,000)

40.050
<6.605>
33.445 ?? does not agree with other two MMS impact numbers
1) 80 million
2) [illegible] "

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METHODOLOGY AND ASSUMPTIONS
USED TO
ESTIMATE ROYALTY IMPACT
OF
MMS COAL VALUATION PROPOSAL
AND
COAL INDUSTRY VALUATION PROPOSAL

Identification of Documents

- Attachment 1 is a copy of the original coal industry submittal which estimates the dollar impacts of the industry royalty valuation proposal.

- Attachment 2 is an MMS analysis estimating annual royalty receipts for the years 1987-1991 under current rules; MMS's January 15, 1987, proposed rules; and for 1990 under the coal industry valuation proposal.

Methodology and Assumptions Used by the Coal Industry

- The coal industry did not provide an explanation of the sources, methodology, or assumptions used to formulate its royalty impact estimate. In certain instances MMS was able to deduce the source of information or replicate the calculations.

- The MMS is unaware of the source documents or methods employed by industry to determine the following categories of information:

  - Price ($/Ton)
  - Severance/production tax
  - Processing allowance
  - Federal excise tax, black lung, abandoned mine land (aml) fee
  - Royalty

- Industry computed the expected Federal production for 1990, by State, by inflating (or deflating) 1986 Federal production tonnage at the following annual rates:

  - Colorado: - 0.30%
  - Montana: 2.86%
  - New Mexico: 11.27%
  - Wyoming: 2.40%
  - Utah: 19.83%

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- North Dakota: - 3.11%

- The 1986 tonnage figures were extracted from the Federal Coal Management Report, Fiscal Year 1986.

- The industry projected Federal Royalty Receipts for 1990 were calculated by multiplying price/ton times expected Federal production for 1990. Those products were then multiplied by the prevailing royalty rate to determine annual royalty receipts.
  - All production was assumed to occur from leases with ad valorem (percentage) royalty rates.
  - The following royalty rates were used: Colorado (surface), 12.5%; Colorado (underground), 8%; Montana, 12.5%; New Mexico, 12.5%; Wyoming, 12.5%; Utah, 8%; and North Dakota 12.5%.

- MMS noted computation errors in the industry submittal as follows: Colorado (surface) projected 1990 royalty receipts should be $19.176 million; Colorado (underground) projected 1990 royalty receipts should be $6.127; and Utah projected 1990 royalty receipts should be $31.280.

- Actual 1986 royalty receipts were extracted from the Federal Coal Management Report, Fiscal Year 1986. The 1986 royalty receipts shown for New Mexico were copied incorrectly. The correct New Mexico royalty receipts stated in the Federal Coal Management Report, Fiscal Year 1986 is $15.402 million.

Methodology and Assumptions Used in MMS Royalty Impact Analysis

- Coal values were derived on a lease- and mine-specific basis using available royalty information reported to the Minerals Management Service (MMS) in the first half of Calendar Year 1987. Where actual lease-specific information was unavailable, MMS employed coal values from nearby leases. Knowledge of market conditions and professional judgment were also used to establish coal values in certain instances when other methods could not be used.

- The coal values determined for 1987 were used for years 1988-1991 without escalation. According to Coal Week (Vol. 13, No. 47, Nov. 24, 1986) "Coal prices will continue to remain flat for years . . . ."

- Calendar Year 1987 tonnage was determined by doubling actual reported tonnage for the first half of that year. Tonnage figures were compiled on a lease-by-lease basis.

- Tonnage estimates for year 1988-1991 were determined by increasing prior year tonnage by 2 percent. The 2 percent production increase per year is based on the following publications. The publication Wyoming Geo-Notes No. 14 (April 1987) by the Geological Survey of Wyoming forecasts (p. 19) an average annual growth rate of 2 percent for Wyoming coal production through

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1991. The Annual Outlook for U.S. Electric Power 1986 published by the Energy Information Administration of the U.S. Department of Energy projects (p. 14) a nationwide growth rate in coal generated electric power to be 12.15 percent over the 5-year period 1985-1990. This is equivalent to a 2.43 percent growth rate per year. Some mines were affected by strikes or mine fires in 1987. For leases in those mines MMS considered the curtailed 1987 production figures to represent inappropriate base year tonnages for purposes of estimating 1988-1991 annual tonnage. In these instances MMS selected 1986 tonnage figures to forecast for the years 1988-1991.

- Estimated royalty receipts for all years were calculated using each individual lease's effective royalty rate. Therefore, projected royalty receipts for each lease recognized and incorporated anticipated changes in royalty revenues as each lease is readjusted and becomes subject to ad valorem royalty rates. The MMS disregarded administrative appeals and lawsuits that have been filed to contest lease readjustment.
- Royalty receipts under current rules were calculated including all reimbursements for taxes, fees, or royalties. The current coal royalty valuation regulations require all reimbursements received by the lessee to be included in the value for royalty purposes.
- Royalty receipts calculated under the January 15, 1987, MMS proposed rules excluded only those reimbursements for the Abandoned Mine Land Fee and the Black Lung Excise Tax from the value for royalty purposes.
- The Abandoned Mine Reclamation Fee applied in this analysis as taken from the Surface Mining Control and Reclamation Act of 1977 is as follows:
  - Surface mining rate: $0.35 per ton
  - Underground mining rate: $0.15 per ton
  - Lignite mining rate: $0.10 per ton
- The Black Lung Excise Tax applied in this analysis as taken from the Black Lung Benefits Revenue Act of 1977 is as follows:
  - Surface mining rate: 4.4% of value but not to exceed $0.55 per ton.
  - Underground mining rate: 4.4% of value but not to exceed $1.10 per ton.
  - Lignite mining is exempt.
- The projected royalty receipts for 1990 under the coal industry proposal, which excludes state severance/production taxes, processing allowances, Federal excise taxes plus AML fees, Black Lung excise taxes and royalty payments was calculated by subtracting the industry-supplied amounts (recomputed to conform to MMS's tonnage estimate) from MMS's projected 1990 Federal royalty receipts under existing regulations.

ICATIONS OF EXCLUDING "TAXES" FROM THE FEDERAL ROYALTY RATE
MATES FOR 1990
lions of dollars)

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	Colorado (surface)	Colorado (ug.)	Montana	New Mexico	Wyoming	Utah	North Dakota
e ($/ton)	23.00	23.00	14.00	25.00	10.00	23.00	10.00
rance/ prod. tax ($)	.7	.4	7.0	1.3	16.8	0.00	.6
essing allowance ($)	.9	.4	1.9	1.0	6.6	2.3	.3
ral excise tax ($) ack lung, aml	1.1	.5	2.9	1.1	11.6	2.3	.6
lty ($)	2.1	1.1	4.7	2.4	12.5	5.6	2.0
cted Fed. Prod. 1990 tual - 1986	6.67 10.121	3.33	25.00 22.433	7.00 4.025	120.00 109.407	17.00 9.400	6.00 6.053
ected Fed. Royalty -1990 tual - 1996	19.167 20.032	6.133	43.750 17.054	21.075 17.402	150.00 28.676	31.200 12.326	7.500 6.670
ected Royalty th Exclusions ction ($)	14.36 18.09	3.73	27.25	16.00	102.50	21.	4.
	4.8	2.4	16.5	5.8	47.50	10.2	3.5
% Inc. over 1986)	(9)		53%	(7)	257%	70%	(40)
ected Royalty Excluding ly Federal Fees ($) (3¢ Volume)	20.5		36.15.	18.30	125 119.3	21.3	4.9
% Inc. over 1986)	2		102	6	316% 355	89	(26)

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FEDERAL COAL LEASES
SIX STATE TOTAL
COLORADO, MONTANA, NEW MEXICO, NORTH DAKOTA, UTAH, WYOMING

ECAST EAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
1987	$164,030,000 Includes Reimbursement for Black Lung $5,630,000 AML $3,510,000	$ 82,020,000				
988	$196,850,000 Includes Reimbursement for Black Lung $7,030,000 AML $4,650,000	$ 98,420,000	$185,170,000 Excludes Reimbursement for Black Lung $7,030,000 AML $4,650,000	$ 92,580,000		
989	$205,710,000 Includes Reimbursement for Black Lung $7,360,000 AML $4,890,000	$102,860,000	$193,440,000 Excludes Reimbursement for Black Lung $7,360,000 AML $4,890,000	$ 96,720,000		
990	$218,310,000 Includes Reimbursement for Black Lung $7,890,000 AML $5,320,000	$109,160,000	$205,060,000 Excludes Reimbursement for Black Lung $7,890,000 AML $5,320,000	$102,530,000	$138,010,000 Excludes Reimbursement for Severance/prod. tax $23,700,000 Processing All. $11,800,000 Federal Excise tax $ 4,690,000 Black Lung $ 7,890,000 AML $ 5,320,000 Royalty $26,900,000	$ 69,005,000*
991	$250,150,000 Includes Reimbursement for Black Lung $9,450,000 AML $6,500,000	$125,080,000	$234,210,000 Excludes Reimbursement for Black Lung $9,450,000 AML $6,500,000	$117,110,000		

dustry computations as adjusted to MMS production projections.

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FEDERAL COAL LEASES
STATE OF COLORADO

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ECAST EAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
987	$ 16,580,000 Includes Reimbursement for Black Lung $ 780,000 AML $ 340,000	$ 8,790,000				
988	$ 17,480,000 Includes Reimbursement for Black Lung $ 760,000 AML $ 360,000	$ 8,740,000	$ 16,360,000 Excludes Reimbursement for Black Lung $ 760,000 AML $ 360,000	$ 8,180,000		
989	$ 18,340,000 Includes Reimbursement for Black Lung $ 790,000 AML $ 390,000	$ 9,170,000	$ 17,160,000 Excludes Reimbursement for Black Lung $ 790,000 AML $ 390,000	$ 8,580,000		
990	$ 18,700,000 Includes Reimbursement for Black Lung $ 800,000 AML $ 400,000	$ 9,350,000	$ 17,500,000 Excludes Reimbursement for Black Lung $ 800,000 AML $ 400,000	$ 8,750,000	$ 10,800,000 Excludes Reimbursement for Severance/prod. tax $ 1,200,000 Processing All. $ 1,500,000 Federal Excise tax $ 500,000 Black Lung $ 800,000 AML $ 400,000 Royalty $ 3,500,000	$ 5,400,000*
991	$ 19,370,000 Includes Reimbursement for Black Lung $ 840,000 AML $ 400,000	$ 9,190,000	$ 18,130,000 Excludes Reimbursement for Black Lung $ 840,000 AML $ 400,000	$ 9,070,000		

dustry computations as adjusted to MMS production projections.

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[illegible]
STATE OF MONTANA

RECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: STATE SHARE
1987	$ 29,110,000 Includes Reimbursement for Black Lung $1,060,000 AML $ 780,000	$ 14,555,000				
1988	$ 29,680,000 Includes Reimbursement for Black Lung $1,080,000 AML $ 800,000	$ 14,840,000	$ 27,800,000 Excludes Reimbursement for Black Lung $1,080,000 AML $ 800,000	$ 13,900,000		
1989	$ 30,270,000 Includes Reimbursement for Black Lung $1,100,000 AML $ 810,000	$ 15,135,000	$ 28,350,000 Excludes Reimbursement for Black Lung $1,100,000 AML $ 810,000	$ 14,175,000		
1990	$ 30,880,000 Includes Reimbursement for Black Lung $1,130,000 AML $ 830,000	$ 15,440,000	$ 28,880,000 Excludes Reimbursement for Black Lung $1,130,000 AML $ 830,000	$ 14,440,000	$ 17,680,000 Excludes Reimbursement for Severance/prod. tax $5,600,000 Processing All. $1,500,000 Federal Excise tax $ 340,000 Black Lung $1,130,000 AML $ 830,000 Royalty $3,800,000	$ 8,840,000*
1991	$ 32,180,000 Includes Reimbursement for Black Lung $1,190,000 AML $ 880,000	$ 16,090,000	$ 30,110,000 Excludes Reimbursement for Black Lung $1,190,000 AML $ 880,000	$ 15,055,000		

*Industry computations as adjusted to MMS production projections.

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ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF NEW MEXICO

FORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES TOTAL REVENUE	STATE SHARE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES TOTAL REVENUE	STATE SHARE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL TOTAL REVENUE	STATE SHARE
1987	$ 9,810,000 Includes Reimbursement for Black Lung $ 210,000 AML $ 130,000	$ 4,905,000				
1988	$ 11,000,000 Includes Reimbursement for Black Lung $ 230,000 AML $ 150,000	$ 5,500,000	$ 10,620,000 Excludes Reimbursement for Black Lung $ 230,000 AML $ 150,000	$ 5,310,000		
1989	$ 11,230,000 Includes Reimbursement for Black Lung $ 240,000 AML $ 150,000	$ 5,615,000	$ 10,830,000 Excludes Reimbursement for Black Lung $ 240,000 AML $ 150,000	$ 5,415,000	This does not exist !!	
1990	$ 11,450,000 Includes Reimbursement for Black Lung $ 240,000 AML $ 160,000	$ 5,725,000	$ 11,050,000 Excludes Reimbursement for Black Lung $ 240,000 AML $ 160,000	$ 5,525,000	$ 8,450,000 Excludes Reimbursement for Severance/prod. tax $ 700,000 Processing All. $ 500,000 Federal Excise tax $ 200,000 Black Lung $ 240,000 AML $ 160,000 Royalty $1,200,000 [illegible]	$ 4,225,00
1991	$ 11,670,000 Includes Reimbursement for Black Lung $ 250,000 AML $ 160,000	$ 5,835,000	$ 11,270,000 Excludes Reimbursement for Black Lung $ 250,000 AML $ 160,000	$ 5,635,000		

*Industry computations as adjusted to MMS production projections.

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ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF NORTH DAKOTA

ORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
1987	$ 5,440,000 Includes Reimbursement for Black Lung $ - AML $ 60,000	$ 2,720,000				
1988	$ 7,480,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,740,000	$ 7,400,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,700,000		
1989	$ 7,630,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,815,000	$ 7,550,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,775,000	$ 3,780,000 Excludes Reimbursement for Severance/prod. tax $ 700,000 Processing All. $ 300,000 Federal Excise tax $ 620,000 Black Lung $ - AML $ 80,000 Royalty $2,300,000	$ 1,890,000*
1990	$ 7,780,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,890,000	$ 7,700,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,850,000		
1991	$ 7,780,000 Includes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,970,000	$ 7,860,000 Excludes Reimbursement for Black Lung $ - AML $ 80,000	$ 3,430,000		

*Industry computations as adjusted to MMS production projections.

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ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF UTAH

ORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES		ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES		ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL	
	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE	TOTAL REVENUE	STATE SHARE
1987	$ 31,210,000 Includes Reimbursement for Black Lung $1,150,000 AML $ 160,000	$ 15,605,000				
1988	$ 32,440,000 Includes Reimbursement for Black Lung $1,170,000 AML $ 170,000	$ 16,220,000	$ 31,100,000 Excludes Reimbursement for Black Lung $1,170,000 AML $ 170,000	$ 15,550,000		
1989	$ 33,480,000 Includes Reimbursement for Black Lung $1,210,000 AML $ 170,000	$ 16,740,000	$ 32,100,000 Excludes Reimbursement for Black Lung $1,210,000 AML $ 170,000	$ 16,050,000		
1990	$ 34,160,000 Includes Reimbursement for Black Lung $1,240,000 AML $ 180,000	$ 17,080,000	$ 32,740,000 Excludes Reimbursement for Black Lung $1,240,000 AML $ 180,000	$ 16,370,000	$ 25,760,000 Excludes Reimbursement for Severance/prod. tax $ - Processing All. $1,900,000 Federal Excise tax $ 480,000 Black Lung $1,240,000 AML $ 180,000 Royalty $4,600,000	$ 12,880,000*
1991	$ 34,840,000 Includes Reimbursement for Black Lung $1,260,000 AML $ 180,000	$ 17,420,000	$ 33,400,000 Excludes Reimbursement for Black Lung $1,260,000 AML $ 180,000	$ 16,700,000		

Industry computations as adjusted to MMS production projections.

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ROYALTY IMPACT ANALYSIS
FEDERAL COAL LEASES
STATE OF WYOMING

FORECAST YEAR	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS CURRENT RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS JANUARY 15, 1987 MMS PROPOSED RULES: STATE SHARE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: TOTAL REVENUE	ESTIMATED ROYALTY RECEIPTS COAL INDUSTRY PROPOSAL: STATE SHARE
1987	$ 71,880,000 Includes Reimbursement for Black Lung $2,430,000 AML $2,040,000	$ 35,860,000				
1988	$ 98,770,000 Includes Reimbursement for Black Lung $3,790,000 AML $3,090,000	$ 49,300,000	$ 91,890,000 Excludes Reimbursement for Black Lung $3,790,000 AML $3,090,000	$ 45,860,000		
1989	$104,760,000 Includes Reimbursement for Black Lung $4,020,000 AML $3,290,000	$ 52,290,000	$ 97,450,000 Excludes Reimbursement for Black Lung $4,020,000 AML $3,290,000	$ 48,640,000		
1990	$115,340,000 Includes Reimbursement for Black Lung $4,480,000 AML $3,670,000	$ 57,580,000	$107,190,000 Excludes Reimbursement for Black Lung $4,480,000 AML $3,670,000	$ 53,510,000	$ 71,540,000 Excludes Reimbursement for Severance/prod. tax $15,500,000 Processing All. $ 6,100,000 Federal Excise tax $ 2,550,000 Black Lung $ 4,480,000 AML $ 3,670,000 Royalty $11,500,000	$ 35,770,000[*]
1991	$144,150,000 Includes Reimbursement for Black Lung $5,910,000 AML $4,800,000	$ 71,990,000	$133,440,000 Excludes Reimbursement for Black Lung $5,910,000 AML $4,800,000	$ 66,630,000		

[*] Industry computations as adjusted to MMS production projections.

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CONSOLIDATED SCHEDULE OF TAX AND ROYALTY COSTS
IN SIX WESTERN STATES
(Calendar Year 1986 Average Prices and Costs Used)

All Figures Expressed on a Dollar-Per-Ton Basis and as a Percent of Sales Price

State	Sales Price**	Royalty Cost	State Severance Tax	AML Fee	Black Lung Tax	Total Deducti
Colorado	$18.92 (Deep & surface not separated)	$2.36/$1.51* 12.5%/8%	$0.799 4.22%	$0.35/$0.15* 1.85%/0.79%	$0.55/$0.83* 2.91%/4.39%	$4.06/$3.2 21.46%/17.
Montana	$12.61	$1.58 12.5%	$3.78 30%	$0.35 2.78%	$0.55 4.36%	$6.26 49.64%
New Mexico	$23.76	$2.97 12.5%	$1.065 4.48%	$0.35 1.47%	$0.55 2.31%	$4.94 20.79%
North Dakota	$11.34	$1.42 12.5%	$1.04 9.17%	$0.10 0.88%	$ 0 0%	$2.56 22.58%
Utah	$28.45	$2.28 8%	$ 0 0%	$0.15 0.53%	$1.10 3.87%	$3.53 12.41%
Wyoming	$13.52	$1.69 12.5%	$1.42 10.5%	$0.35 2.59%	$0.55 4.07%	$4.01 29.66%

Percentage reduction in overall value is shown below dollar reduction.

* Cost relevant to surface-mined coal stated first, followed by costs applicable to underground-mined coal.

** Based on average price as a result of mine by mine analysis by MMS of contracts or values reported by industry.